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John W. Lee
William & Mary Law School, jwleex@wm.edu

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SHAREHOLDER WITHDRAWAL—LOAN OR DIVIDEND:
REPAYMENTS, ESTOPPEL, AND OTHER ANOMALIES

John W. Lee*

The conduct of a business venture through the corporate form carries with it the possibility of "double taxation"—one tax at the corporate level on the profits of the venture and a second tax at the shareholder level on the distribution of such profits to the shareholders. As a general rule profit distributions cannot safely be postponed indefinitely by a corporation due to the accumulated earnings tax imposed on a corporation formed or availed of for the purpose of avoiding income tax at the shareholder level by permitting earnings and profits to accumulate instead of distributing them. Consequently, taxpayers who have

*A.B., University of North Carolina, 1965; LL.B., University of Virginia, 1968; LL.M. in Taxation, Georgetown University, 1970; Member of the firm: Hirschler and Fleischer, Richmond, Virginia.

1. For a comparison of the alternative modes of conducting a business venture see CCH Tax Analysis Series, Tax Choices in Organizing a Business (1969).

2. A corporation exercising a Subchapter S election, Int. Rev. Code of 1954, §§ 1371-79 as amended, (hereinafter cited as IRC) usually avoids this problem of double taxation because, as a general rule, the corporation is relieved from taxation; and each stockholder reports his share of the corporation's income and losses (which retains the same character as it had in the hands of the corporation) whether distributed to him or not (increasing the basis of his stock in the latter event). See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 709-739 (2d ed. 1966) [hereinafter cited as Bittker & Eustice]. A significant exception to no taxation at the corporate level is contained in IRC § 1378. In 1966, that section was enacted to prevent a "one-shot" election whereby a substantial capital gain could be passed through to the shareholder. An additional capital gain tax is imposed at the corporate level on such gains in excess of $25,000, if the corporation's ordinary income is less than its capital gains and it has not been a Sub. S corporation for the prior three years, or since its inception, whichever is the lesser. See D. Herwitz, Business Planning 154 (1966).

3. IRC §§ 531-537. See generally CCH Tax Analysis Series, The Tax on Accumulated Earnings (1968). The Supreme Court's recent decision in United States v. Donruss Co., 393 U.S. 297 (1969), resolved a conflict as to whether, after it has been established that the corporation did accumulate beyond reasonable needs, a taxpayer could prove that the purpose for such accumulation was not motivated by tax avoidance if he showed other non-tax reasons for it. The Court held that the taxpayer could rebut the presumption of tax avoidance only by showing that it was not even one of the purposes for the accumulation. Davies, 1969 Leading Federal Tax Cases, WM. & MARY 15th Tax Conf. 18, 29-30 (1969). If the question of unreasonable accumulations is tried in the Tax Court, the government may have the burden of proof under complicated provisions contained in IRC § 534—such burden is commonly on the taxpayer with certain significant expectations, primarily in fraud cases and where new issues have been raised by the Commissioner. Tax Ct. R. 32. Until recently, however, this Code section
organized a transaction in the corporate mold often seek to structure distributions from the corporation so that if they are taxed to the shareholder they are deductible by the corporation against its gross income, or if they are non-deductible by the corporation they are not taxable to the shareholders. Some of the most common arrangements used to effectuate the former goal of corporate deductions are payments of interest on shareholder held debt-instruments, rental payments to a shareholder-lessor, royalty payments to a shareholder for use of a

was for all practical purposes a dead letter because the Tax Court had steadfastly refused to rule in advance of trial as to whether the taxpayer had shifted the burden of proof to the government and, moreover, frequently concluded after trial that one party or the other prevailed regardless of burden of proof. See, e.g., Pelton Steel, 28 T.C. 153 (1957), aff'd, 251 F.2d 78 (7th Cir. 1958). See generally Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573 (1959). However, in Chatham Corp., 48 T.C. 145 (1967), the taxpayer submitted a 49 page statement setting forth two grounds for its retention of earnings and profits, which the Tax Court found sufficient to shift the burden of proof to the government with respect to those grounds.

4. Under IRC § 163 a taxpayer is entitled to a deduction for all interest paid or accrued within the taxable year on indebtedness. Since distributions of dividends are not deductible against the corporation's taxable income, the primary area of litigation here has been whether the debt instrument constitutes debt or equity. See generally Britter & Eustice 121-38. For a list of the other areas in which the debt-equity issue can arise see Edwin C. Hollenbeck, 50 T.C. 740, 747 (1968). The court also pointed out that principles were the same regardless of the context in which the issue arose. Hopefully, some of the controversy in this area will be lessened when Treasury issues the legislative regulations under new IRC § 385 which are to set forth the factors to be applied in determining whether a debtor-creditor or corporation-shareholder relationship exists. In IRC § 385, Congress has suggested that such factors may include the following: (1) form, (2) subordination, (3) debt-equity ratio, (4) convertability, and (5) pro rata holdings. For the prior development of this area see Caplin, The Caloric Count of a Thin Incorporation, N.Y.U. 17TH INST. ON FED. TAX. 771 (1959); Horsley, New Dimensions to the Thin Corporation, 9 WM. & MARY L. Rev. 1066 (1968). Even if the debt-instrument is deemed a true debt, an accrual basis corporation will not be permitted a deduction for accrued interest owed to a 50% or more shareholder (assuming that he is on the cash basis method of accounting) unless the interest is actually paid as accrued. IRC § 267 (a) (2), (b) (2).

5. See Comment, Disguised Dividends: A Comprehensive Survey, 3 U.C.L.A. L. Rev. 207, 216-19 (1956). Retention by a stockholder of operating assets and leasing them to the corporation is often suggested as an attractive alternative to stockholder debt. See, e.g., D. Herwitz, supra note 2, at 149. However, it should be noted that the Commissioner has the authority under Treas. Reg. § 1.482-2(c) to make appropriate allocations to properly reflect an arm's length rental charge for the leasing of tangible property by one member of a controlled group to another. See generally Jenks, Treasury Regulations under Section 482, 23 THE TAX LAWYER, 279, 301-02 (1970). It is now well established that an individual and a corporation can constitute a controlled group. See, e.g., Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), cert. denied, 395 U.S. 933 (1969). What is less clear is whether, if a transaction, such as leasing tangible property to a member of a controlled group, is colorably within the purview of IRC § 482, the Service may apply
licensed item, trade secrets, excessive compensation for a shareholder's services, and patronage dividends in the case of corporations organized as cooperatives. On the other hand, techniques frequently utilized to avoid taxation at the shareholder level are bargain purchases or sales, gifts, e.g., cancellation of debt owned by a shareholder, repayments of principal as to shareholder held debt-instruments, and loans to shareholders. Focusing on shareholder withdrawals structured as non-

a different remedy, such as the constructive dividend doctrine, to achieve a similar result. For in Rubin v. Comm'r, 429 F.2d 650, 653-54 (2d Cir. 1970), reversing 51 T.C. 251 (1968), the court held that where IRC § 482 is adequate to deal with a problem, resort to "common law" doctrines of taxation (assignment of income) and the broad sweep of IRC § 62 may not be had.


7. IRC § 162 (a) (1) provides for a deduction of business expenses including "a reasonable allowance for salaries or other compensation for personal services actually rendered." Much controversy has risen as to what is reasonable. See generally Meyer, Reasonableness of Compensation—A Tabular Review, N.Y.U. 26TH INST. ON FED. TAX. 1121 (1968). Moreover, this problem is acerbated in closely-held corporations in which no dividends are paid and the net profits are paid to the dominant shareholder-employees in the form of compensation. See Holden, Has the Court of Claims Adopted an "Automatic Dividend" Rule in Compensation Cases?, 32 J. TAXATION 311 (1970); Note, Is Compensation Based on a Percentage of Earnings Automatically Unreasonable?, 33 J. TAXATION 228 (1970). The regulations provide that "in the case of excessive payments by corporations, if such payments correspond to bear a close relationship to stockholding, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend . . . ." Treas. Reg. § 1.162-8.

8. The tax treatment under the Internal Revenue Code for corporations operating on a co-operative basis is provided in Subchapter T, Co-operatives and Their Patrons, IRC §§ 1381-88. The tax treatment in a nutshell of a mercantile co-op is as follows: Although subject to the corporate income tax it receives a deduction for patronage dividends paid in money or in qualified written notices of allocation (paper allocations) with respect to patronage. If 20% of such dividends is paid in cash and the balance in the form of paper allocations, the co-op can retain and invest earnings on a tax free basis. As a general rule, the patron must include the patronage dividend in income when received; however, there is a very significant exception for distributions received with respect to a capital asset or depreciable property used in the patron's trade or business. See generally Caplin, Taxing the Net Margins of Cooperatives, 38 Geo. L.J. 6 (1969); Logan, Federal Income Taxation of Farmers and Other Cooperatives, Part II, 44 TEXAS L. REV. 1269 (1966).

9. A bargain sale of stock to an employee because he is an employee is a compensatory sale with the amount of the bargain constituting income. Commissioner v. Lobue, 351 U.S. 243 (1966). The same principle is applied in the constructive dividend area where property is sold at a bargain to, or bought at a bargain from, a stockholder because of his status as such. Treas. Reg. § 1.301-1(j). See Comment, supra note 5, at 208-15.

10. See Comment, supra note 5, at 234-36.

11. This is but another aspect of the debt-equity area commented on in note 4 supra.

12. See Note, Stockholder Withdrawals—Loans or Dividends?, 10 TAX L. REV. 569 (1955). Where a taxpayer has attempted to avoid dividend treatment, through characterizing a distribution as a loan, but such character is disputed on audit, it may be too
taxable loans, the problem is that the Internal Revenue Service seeks to characterize them as dividends under IRC § 316, commonly designated constructive dividends, since no formal corporate declarations of a dividend have been made with respect to the distributions, or disguised dividends, since they were structured to avoid dividend treatment.

Not surprisingly, this question of whether a withdrawal of funds by a shareholder from a corporation, commonly closely held, constitutes a bona fide loan or a constructive dividend has been frequently litigated. Although a variety of tax consequences turn on the resolution of this issue, e.g., the possibilities of interest income to the corporation, a bad debt deduction to the corporation, an interest deduction to the shareholder, dividend income to the shareholder, the focus of the

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The determinative inquiry is whether the parties to the transaction intended at the time of the withdrawal that it would be repaid. Although this factual question must be determined from all of the surrounding circumstances, and no single factor is determinative, one of the most significant factors is whether the withdrawal was in fact repaid. Therefore, the effect of repayment on the issue of loan versus dividend will be examined, although it must be kept in mind that the facts of a case are seldom all black or white and frequently in a given case other factors or the cumulative effect of all factors will be decisive. It should be further noted at the outset that repayment arises in a number of differing factual patterns which can color the result: full or part repayment, the timing of the repayment, the offsetting of the repayment by further withdrawals, and the source of repayment—whether included in gross income to the extent that it is a dividend. IRC §§ 301(a), (c), 317(a). The term dividend is defined in note 13 supra.

18. Chism's Estate v. Comm'r, 322 F.2d 956, 960 (9th Cir. 1963); Estate of Helene Simmons, 26 T.C. 409, 423 (1956).
23. Other factors, beyond the scope of this article, which are often significant are as follows: 1) ability of shareholder to repay, 2) giving of collateral, 3) complete control of corporation by taxpayer or his family, 4) treatment of withdrawal on corporate records, 5) dividend policy of the corporation, 6) ratio of advances to earnings and profits of the corporation, 7) payment of interest, 8) purpose for which loan was used, 9) ratio of disbursements to stockholdings, 10) issuance of notes, and 11) whether loan was ultra vires or unlawful. Note, supra note 12; Comment, supra note 5, at 222-28. See generally 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 9.21 [hereinafter cited as MERTENS]; J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 21.05 [hereinafter cited as RABKIN & JOHNSON].
24. See notes 33 to 42infra and accompanying text.
25. See notes 43 to 56infra and accompanying text.
26. See notes 60 to 65infra and accompanying text.
27. See notes 66 to 81infra and accompanying text.
it is made in cash or by credits for salary or bonuses from the corporation. Moreover, the pattern of withdrawals and repayment prior to the taxable years can have a decisive effect.28

Although the question commonly arises at the time of withdrawal, with the Commissioner asserting that the distribution is a constructive dividend and the taxpayer maintaining that it was a bona fide loan, the issue can also arise at a later date when the "loan" is cancelled or the corporation is dissolved.29 In the latter situation, in a curious reversal of roles, the taxpayer earnestly claims that the advances were, in fact, intended to be dividends (on which the statute of limitations has run); the Service claims that the withdrawals were loans when made, but that the cancellation constitutes a constructive dividend. Furthermore, an inconsistency of positions frequently occurs when only some of the withdrawals took place in years barred by the statute of limitations. Where the distributions in the barred years, if dividends, would exhaust accumulated earnings and profits, the Service has asserted that the distributions in open years constituted constructive dividends while maintaining that similar withdrawals in the closed years were loans.30

Once it is determined that the disbursement was a constructive dividend, a question still exists as to the effect of a repayment on the amount of the withdrawal, i.e., whether the original distribution and repayments in the same or subsequent tax years are to be netted. Assuming that the repayment does not reduce the amount of the dividend, intriguing problems arise as to how the shareholder should treat the repayment—as a loan to the corporation or a contribution to capital, or what.31 Furthermore, what are the tax consequences to the shareholder if upon a court's determination that the distribution was a dividend he recovers the repayment.32 The following analysis examines in detail the various aspects of repayment of shareholder withdrawals outlined above as well as the question of consistent treatment of distributions.

**FULL REPAYMENT**

One commentator has stated that it is difficult for the Commissioner to argue convincingly in the face of full repayment that the original intent was to distribute a dividend which would not have to be repaid.33

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28. See notes 82 to 91 infra and accompanying text.
29. See notes 199 to 200 infra and accompanying text.
30. See notes 233 to 238 infra and accompanying text.
31. See notes 182 to 185 infra and accompanying text.
32. See notes 186 to 192 infra and accompanying text.
33. Comment, supra note 5, at 223.
This position is reflected in those decisions holding that full repayment manifests the shareholder's intent to treat the advances as loans, particularly where the repayment was made before notice of any claim that the withdrawals were in fact dividends. This conclusion has been reached even where the repayment consisted largely of intercorporate credits, or was made only after the taxpayer became aware of the danger that a contention that the advance was a constructive dividend might be raised by the Internal Revenue Service.

Nevertheless, since it is the intention of the shareholder and the corporation at the time of the withdrawal—not at some later date when repayment is made—that is determinative, circumstances at the time of the disbursement theoretically could outweigh a later complete repayment. However, from a practical point of view it is more significant that the two principal cases, A. F. Lowes Lumber Co. and A. W. Mellon, holding that despite full repayment prior to audit a withdrawal was in fact intended to be a distribution of corporate earnings, involved full repayment not by the shareholder but by his estate. Analytically, the manner in which a different party, the executor, treats the advance at some date after distribution has little relationship to the original intent of the shareholder and the corporation. Consequently, whenever repayments, before or after audit, are made by the shareholder's estate, taxpayers can expect the courts to examine very carefully the circumstances surrounding the withdrawal. Thus, in Mellon it was pointed out that the most significant fact was payment by the corporation of a formal dividend in the year in which the advance was made without any effort by it to recoup the outstanding accounts charged against the shareholder. And in A. F. Lowes Lumber Co., until after the share-

36. See George S. Groves, 38 B.T.A. 727, 733 (1938).
37. Irving T. Bush, 45 B.T.A. 609, 623 (1941), rev'd on other grounds, 133 F.2d 1005 (2d Cir. 1943); Moses W. Faitoute, 38 B.T.A. 32, 36 (1938).
38. See note 18 supra and accompanying text.
40. 36 B.T.A. 977, 1026 (1937). In Mellon the taxpayer was one of four shareholders in the corporation; the corporation made no demand for repayment of the withdrawals until the estate of one of the other shareholders acknowledged and repaid its decedent's portion of the "loan." Id.
41. See Chism's Estate v. Comm'r, 322 F.2d 956, 960 (9th Cir. 1963).
42. 36 B.T.A. at 1061.
holder's death withdrawals far exceeded both credits for bonuses re-
turned to the corporation and occasional cash repayments.

In conclusion, where the shareholder himself has made a prompt
total repayment of the advancement or consistent partial repayments
culminating in total repayment prior to audit, such repayment should be
controlling in determining whether the loan was bona fide, but if the re-
payments were made by a different party than the shareholder they
will be given considerably less weight in this determination. The dif-
ferent considerations which come into play when the repayment is
after audit are discussed immediately below.

Repayment After Audit

The timing of repayments is a critical factor. This is because repay-
ment is only significant as the basis for an inference that the withdrawal
was intended to be a bona fide loan.43 If it occurs after an audit in
which the question of disguised dividends was raised, the possibility
that it may have been made only in response to the audit so as to make
the withdrawal appear a genuine loan weakens this inference. An ex-
ample of this may be seen in Leroy B. Williams44 where the taxpayer
did not make any repayment until after audit, and in fact not until after
conviction for criminal tax fraud in a district court. Not surprisingly,
the Tax Court found the repayment to be more of an afterthought than
anything else. Similarly, execution of notes after audit has been de-
scribed as "a mere afterthought directed to an effort to give the with-
drawals a character which they did not have during the years when
they were made. . . ." 45 Other decisions have simply disregarded the
repayments46 or, more commonly, have indicated that the fact that
they were made after audit went far to weaken them as "persuasive ev-
dence of a pre-existing intention to repay the amounts withdrawn," 47
and consequently they had very little probative value.48 Ironically,
after the characterization of an advance as a loan has been questioned

43. 1 MERTENS, § 9.21 n. 43.3 and accompanying text.
46. See Atlanta Biltmore Hotel Corp. v. Comm'r, 349 F.2d 677, 680 (5th Cir. 1965).
See generally Note, supra note 12, at 573.
47. George R. Tollefsen, 52 T.C. 671, 680 (1969), aff'd, No. 34203 (2d Cir., June 19,
1970).
48. Carlos Marcello, P-H Tax Ct. Mem. ¶ 69,193, appeal docketed, No. —, 5th Cir.,
Comm'r, 349 F.2d 677, 680 (5th Cir. 1965); Regensburg v. Comm'r, 144 F.2d 41, 44
(2d Cir.), cert. denied, 323 U.S. 783 (1944).
by the Service, repayment may be considered an indication of a guilty conscience or of no prior plan to repay and hence may weaken the taxpayer's case.

Analytically, repayment after audit should be distinguished from repayments made or notes executed some time after the withdrawals, yet prior to audit, and from repayments on notes which were paid or executed, respectively, at the time of audit but the shareholder had earlier manifested an intent to make the repayments or give the notes. In such circumstances, the stockholder's tardiness should not give rise to a counter-inference that the purpose of repayment was to more effectively disguise what was, in fact, a dividend, for the earlier intent to repay warrants the conclusion that the parties intended from the beginning that the withdrawal be a true loan and be repaid.

The crucial significance of timing also can be seen in such decisions as Albert Ravano in which, even though the court held that the withdrawals were bona fide loans, it stated that repayments after audit were a highly disturbing circumstance. Another court faced with repayments both prior and subsequent to audit pointed out that the repayments, particularly those prior to the audit, evidenced an intention to treat the withdrawal as a genuine loan. The fact that there was no long pattern of withdrawals indicating a systematic extraction of corporate profits was emphasized. Similarly, where repayments were made both prior and subsequent to audit, all repayments were considered, but those after the tax years were not given great weight.

There are, however, older decisions, such as Moses W. Faitoute and Irving T. Bush, which hold that the fact that repayment was made only after the taxpayer became aware of the Commissioner's position that the advancements were constructive dividends was only of circumstantial weight, or even immaterial. This approach is inconsistent with the view that repayment only supports an inference that the shareholder intended, when he made the withdrawal, to later repay it.

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55. 38 B.T.A. 32, 36 (1938).

56. 45 B.T.A. 609, 623 (1941), rev'd on other grounds, 133 F.2d 1005 (2d Cir. 1943).
consequently, it is extremely doubtful that a court would take the same approach today.

By way of summary, a repayment after audit would appear advisable only where there has already been established a pattern of partial repayments, for even where the circumstances surrounding the withdrawal are strongly in the taxpayer's favor a bare post-audit repayment may be a disturbing factor or even weaken the taxpayer's case. Moreover, repayment by a taxpayer is subject to allegations by the Internal Revenue Service that the return of property to the corporation represents a gift to the corporation, a loan to it, or a contribution to the corporation's capital. If the repayment is a gift, then gift tax consequences may attach. Furthermore, if it is deemed a contribution to capital, as contrasted with a loan to the corporation, a later recovery of the repayment might produce dividend income.

**Pattern of Repayments**

The most common context in which controversy over the effect of repayment has arisen is that of partial repayments. And these partial

57. Cf. Fender Sales, Inc., P-H Tax Ct. Mem. ¶ 63,119, modified on other grounds, 338 F.2d 924 (9th Cir. 1964), cert. denied, 382 U.S. 813 (1965). There the taxpayer in the same tax year in which he was to receive his bonus payment offered to return it to the company, and this offer was accepted. The taxpayer argued that where in the year of receipt the recipient renounces his right to income and repays the owner, the claim of right doctrine is not applicable and he is not to be taxed on the amounts returned. The Commissioner argued that the taxpayer "never intended to reduce his compensation and that the return of the bonuses represented in the disjunctive a gift to Instrument [the corporation], a partial payment of . . . [the taxpayer's] indebtedness to Instrument, a loan to Instrument or a contribution to Instrument's capital. . . ." The court agreed with the taxpayer, holding that where there has been an adjustment of a contract or obligation prior to the close of the taxable year and a repayment of a portion of the amount received, the tax liability is based on the adjusted amount. The claim of right doctrine is discussed in note 127 infra.

58. See IRC §§ 2501, 2053(a), 2053(b), 2521. Gift Tax Reg. § 25.2511-1(h) provides that if a transfer of property by an individual to a corporation is not made for adequate and full consideration in money or money's worth, it represents gifts by him to the other stockholders. A transfer by a sole stockholder has been treated as a contribution to capital rather than as a gift on the ground that enhancement of the value of his shares constituted consideration. Robert H. Scanlon, 42 B.T.A. 997 (1940). See generally Note, Gifts to Closely Held Corporations, 57 Colum. L. Rev. 248-49 (1957). Moreover, it has been suggested that whenever the transfer is made in business context it should be treated as contribution to capital. Landis, Contributions to Capital of Corporations, 24 Tax L. Rev. 241, 246-47 (1969). This position is supported by Gift Tax Reg. § 23.2312-8 (transfer in ordinary course of business considered as made for adequate consideration).

59. See text accompanying note 187, infra.
repayments occur most frequently in open accounts continuing over an extended period—where repayments are offset or partially offset by further withdrawals.\textsuperscript{60} Again, there is a split or, more precisely, a splintering of authorities: at one end of the spectrum is the attitude that if the withdrawals were in fact disguised dividends there would have been no point in repayments or an active in and out open account;\textsuperscript{61} at the other end, is the attitude that such repayments constitute a purely artificial procedure,\textsuperscript{62} best typified by the actions of a taxpayer who at the end of each year borrowed funds from a bank to repay that year's withdrawals, but at the beginning of the succeeding year immediately made further withdrawals to repay the bank.\textsuperscript{63} Between these extremes the most important factors are the actual form of the repayments—cash or credits for salary, bonuses, and dividends\textsuperscript{64}—and whether the debit column in the open account steadily increased during a long period of time.\textsuperscript{65}

\textit{Credits for Salary and Bonus}

The tenor of many cases indicates a distinction between actual cash repayments and credits for salary, etc.\textsuperscript{66} This discrimination is most clearly articulated in the recent Tax Court decision, \textit{George R. Tollefson}.\textsuperscript{67} There, withdrawals were made and entered in an open account, and certain credits consisting primarily of accrued salary were also entered in it. The court stated that no formal repayments had been made, thereby excluding such credits from the category of formal repayments. Similarly, in dismissing the taxpayer's contention that various repayments indicated his bona fide intention of treating the withdrawals as loans, the court, in \textit{Fender Sales, Inc.},\textsuperscript{68} ex-

\textsuperscript{62} See, e.g., \textit{Ben R. Meyer}, 45 B.T.A. 228, 238 (1941).
\textsuperscript{63} \textit{Atlanta Biltmore Hotel Corp. v. Comm'r}, 349 F.2d 677 (5th Cir. 1965).
\textsuperscript{64} See Note, \textit{supra} note 12, at 574.
\textsuperscript{66} The term credit for salary means the practice whereby the salary is not actually received by the taxpayer but is instead offset against the open account through a bookkeeping entry. See \textit{Harry Hoffman}, P-H Tax Ct. Mem. \textsection 67,158. A taxpayer may be taxed on salary not actually received under the doctrine of constructive receipt. See note 127 \textit{infra}.
\textsuperscript{68} P-H Tax Ct. Mem. \textsection 63,119, \textit{modified on other grounds}, 338 F.2d 924 (9th Cir.
plicitly noted "that such repayments were in fact credits to the account occasioned for the most part by . . . [the taxpayer's] relinquishment of his rights to certain salary, bonus, or rental payments. . . ." Other cases have not articulated this distinction so explicitly, but nevertheless clearly have been influenced by the fact that the only repayments to an open account were credits for accrued salary or a formal dividend.69

Yet this outcome is not inevitable: where the only repayments were in the form of credits for salary or dividends, courts have still found the withdrawals to be bona fide loans, particularly where other compelling factors indicating an intention to repay the withdrawals were present. For example, where the shareholder made interest payments by check, which were reported as income by the corporation;70 where the advance was necessitated by an unusual, emergency situation and was vital to the corporation's continued success;71 where the shareholder attempted to obtain funds to repay the loan through outside financing;72 and where the majority stockholder objected strenuously to the excessive withdrawals by the taxpayer and brought suit for repayment in later years,73 the disbursements have been held to be loans even though the only repayments were such credits. Furthermore, the court in *Harry Hoffman* categorically stated that

the fact that the [taxpayer's] salaries and bonuses were not actually

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69. See George P. Marshall, 32 B.T.A. 956-57, 959 (1935) (credit entries for salary adjustment and to reverse prior entries of like amounts of little, if any, benefit to taxpayer in contention that withdrawals were loans); Clarence L. Bibb, P-H Tax Ct. Mem. ¶ 65,296 (no repayments except crediting formal dividend); R. P. Kountz, P-H Tax Ct. Mem. ¶ 62,039 (only nominal credits for 11 years prior to audit other than credits for salary).

70. Rollin C. Reynolds, 44 B.T.A. 342, 346 (1941). *Contra*, Ben R. Meyer, 45 B.T.A. 228, 235-36 (1941) (interest paid by taxpayer on open account was reported by corporation as income but no taxable net income was reported during the years in question).


73. Carl L. White, 17 T.C. 1562, 1568 (1952). *Contra*, A. F. Lowes Lumber Co., P-H Tax Ct. Mem. ¶ 60,141 (anticipated credits to account would repay advances; other partner discovered to horror $376,000 balance and advised against further withdrawals—advances for personal purposes continued).
received but merely offset against the open accounts in bookkeeping entries does not detract from the importance of this form of repayment. This compensation constituted income for tax purposes and income taxes were paid thereon. It cannot be said that repayments in this form are less valid in an economic reality sense than any other form of repayment.\textsuperscript{74}

What the position espoused in \textit{Hoffman} ignores is that by the use of such credits no double tax is paid with respect to any of the distributions: the “loans” are not taxable income to the shareholder and the salary paid and taxed to him is deductible by the corporation (to the extent that such compensation is reasonable).\textsuperscript{76} Thus, where the credits are merely window dressing, the increased tax, if any, on these salaries arising from any differential between corporate and individual rates\textsuperscript{76} is but a cheap price for the tax-free extraction of corporate earnings through the excess of the withdrawals in debits over the credits. Accordingly, courts which place minimum importance on these credits may well be reflecting the attitude that were they given more weight in the determination of whether the parties intended for the advances to be repaid, the taxpayer could, in effect, receive his salary or bonus through the withdrawal and then, by a mere bookkeeping entry, reduce the amount of the “loan” due, but not the actual amount of funds originally received, and yet give the semblance of a loan to the withdrawal.\textsuperscript{77} That tax-

\textsuperscript{74} Harry Hoffman, P-H Tax Ct. Mem. \textsection 67,158. In view of the reasoning in note \textsection 68 supra it is questionable whether the court’s basic premise—that the compensation credited to the account constituted taxable income—was sound. Hence, its conclusion is equally dubious.\textsuperscript{75}

\textsuperscript{75} See note 7 supra.

\textsuperscript{76} For taxable years beginning after 1971, and particularly after 1974, it is less likely that there will be a large differential between the corporate rate and that of a shareholder in a closely held corporation. The maximum tax on earned income for taxable years beginning on or after January 1, 1972, will be 50\%. IRC \textsection 1348. \textit{See generally} Reicher, \textit{Planning for the Earned Income Ceiling Despite Uncertainties in the Rules}, 32 J. Taxation 360 (1970). The combined corporate normal tax and surtax is 48\%. IRC \textsection 11. Although the surtax (26\%) applies only to income exceeding the surtax exemption of \$25,000, IRC \textsection 11(c) and (d), where multiple corporations are involved (principally one or more chains of parent-subsidiary corporations, brother-sister corporations, or combinations of both, IRC \textsection 1563) by reason of the Tax Reform Act of 1969 such corporations will be entitled for all tax years beginning after 1974 to only one surtax exemption which must be divided equally or unequally among them. IRC \textsection 1561. \textit{See generally} Kringel, \textit{Coping with the 1969 Act’s Tough New Rules for Corporate Groups}, 32 J. Taxation 136 (1970).\textsuperscript{77}

\textsuperscript{77} See Note, supra note 12, at 573-74:

In most cases the credits in these running accounts include credits for salaries, dividends, and/or cash repayments. Should a premium be placed on
payers do attempt to use withdrawals as a substitute for salary, and then seek to protect additional extraction of corporate dividends by partially repaying the "loan" through return of their salaries, is clearly seen in those cases in which the taxpayer has his entire salary credited to the open account year after year. More sophisticated variations of this technique, such as declaration of a special dividend, giving of a bonus, and doubling of the shareholder's salary, have also received short shrift.

In *Fender Sales, Inc.*, the court's rejection of the taxpayer's contention that various repayments in the form of credits manifested the bona fides of the withdrawals was clearly influenced by the doctrine (dealt with more fully below in the net withdrawal discussion) that where prior to the close of the taxable year there has been an adjustment of an obligation to pay a certain amount to the taxpayer and a repayment by him of a portion of the amount received, his tax liability is determined on the basis of such adjusted amount. For the court viewed the credits less as repayments and more as relinquishments of the taxpayer's rights to certain salary, bonus, or rental payments, even though, wherever a credit reflected a return of bonus, the taxpayer had reported the bonus as taxable income. While this doctrine is usually applied where the salary is received prior to entry of the credit, *i.e.*, the relinquishment, it should be equally applicable if the receipt of the salary and the credit are simultaneous.

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78. See William C. Baird, 25 T.C. 387, 389 (1955); R. P. Kountz, P-H Tax Ct. Mem. ¶ 62,029. A related, but cruder, device may be found in Jack Haber, 52 T.C. 255, 265 (1969), aff'd, 422 F.2d 198 (2d Cir. 1970) (per curiam), where the taxpayer's closely held corporation made distributions during each tax year which were first recorded in a "payable" or, more correctly, receivable account in his name, then at tax return time the taxpayer determined what part of these amounts were to be considered loans and what part salary. To reflect this determination the taxpayer debited his salary account and credited his loan account. The court concluded that the entire amount constituted compensation for services. The taxpayer in John T. Savage, P-H Tax Ct. Mem. ¶ 70, 158, was even less fortunate, since on similar facts it was held that the entire amount constituted a dividend (hence not deductible to the corporation). *See note 12 supra.*


81. *See notes 100 through 145 infra* and accompanying text.
Focusing more closely on the pattern of advances, it should be noted that the existence of an earlier credit balance to a corporation has frequently been a very significant factor—often unjustifiably so. In one common pattern, the open account begins with a large credit or advance by the shareholder to the corporation. At first blush such a beginning gives the appearance to subsequent withdrawals from the open account of bona fide loans back and forth between the corporation and the shareholder. While transactions in this pattern should be treated as loans where the shareholder and corporation alternatively enjoy the use of the other’s money for different periods, an initial advance can obscure a situation in which the shareholder’s intent changes after the advance, and the balance in the account gradually metamorphoses into a pattern of increasing debits. The weakness of focusing on the initial advance becomes more apparent when one considers a situation in which the original shareholder dies, his heir inherits the credit balance with the corporation, and then the debits begin to exceed the former credit. Moreover, an initial advance followed by withdrawals is always subject to the argument by the Internal Revenue Service that the original advance or loan was, in substance, a contribution to capital, and hence an equity interest with the subsequent advancements or debits constituting constructive dividends. Where withdrawals came first, followed by a large advance to the corporation, the advance is even more subject to the charge that it was a contribution to capital, for the controlling shareholder in a close corporation might be expected to advance funds to his corporation if it were in financial difficulty.

82. Chism’s Estate v. Comm’n, 322 F.2d 956 (9th Cir. 1963); In re Ward, 131 F. Supp. 387 (D.Colo. 1955); Estate of Helene Simmons, 26 T.C. 409 (1956); Albert Ravano, P-H Tax Ct. Mem. ¶ 67,170.
83. See Albert Ravano, P-H Tax Ct. Mem. ¶ 67,170. Note that the “alternative use” contention may not always be successful—in M. Jackson Crispin, 32 B.T.A. 151 (1935), advances by the taxpayer back to the corporation when it needed cash were deemed loans to it, independent of the constructive dividends to the taxpayer. And in Leroy B. Williams, P-H Tax Ct. Mem. ¶ 55,525, the Tax Court held that payments in an open account by a corporation in excess of the amount owed to the taxpayer-shareholder did not represent loans to him but were a distribution of earnings and profits of the corporation.
85. See Estate of Helene Simmons, 26 T.C. 409 (1956) (withdrawals held loans).
87. Cf. Grant Foster, P-H Tax Ct. Mem. ¶ 65,246 (repayments prior to audit not con-
The more common pattern has been for repayments in some earlier years to bring the account into balance\(^8\) or even to exceed the withdrawals in a given year.\(^9\) Certainly, where the taxpayer has consistently and carefully made repayments in order to balance the account and only occasionally closed a year with a large debit account which he then quickly reduced in subsequent years (as was the case in *Alvin H. Phillips*),\(^9\) treatment of the withdrawals as loans is the correct result. Similarly, a history of a balanced account in some years, and in the other years the alternative use by the corporation and the shareholder of each other's money, is a very convincing factor in the taxpayer's favor, even if at the time of the audit there exists a debit balance in the account of several years' standing.\(^9\)

**Increasing Debit Balance**

Where repayments exceed withdrawals in a few isolated years but the debit balance is never eliminated or the amount of net disbursements steadily increases over the years,\(^9\) the advancements are less justifiably treated as loans. Thus, it is not surprising that in one of the leading cases in the disguised dividend area, *Chism's Estate v. Commissioner*,\(^9\) the fact that repayment exceeded withdrawals in a few years was outweighed by the fact that the net distributions increased over a twenty-years' inclusive; taxpayer regarded corporation as his own and quite natural for him to deposit in its account proceeds of personal investment if he thought it needed the cash). Moreover, if the corporation is so hopelessly insolvent at the time of the advance as to preclude any expectation of repayment or if repayment of no more than a small percentage of the amount of the advancement is contemplated, it is presumed that the shareholder is not lending the money but making a capital contribution. See *W. D. Roussel*, 37 T.C. 235, 242 (1961). See generally 5 *Mer tens* § 28.38 at 167. This rule appears closely related to the more recent trend of cases in the debt-equity area in which a decisive factor is whether there was a reasonable expectation of repayment regardless of the success of the venture or whether instead the advances were actually placed at the risk of the business. Gilbert v. Comm'r, 248 F.2d 399, 407 (2d Cir. 1957). *But cf.* George A. Nye, 50 T.C. 203, 215 (1968) (stockholders in creating a corporation have discretion in deciding how much of their funds or assets they care to risk in the form of capital and how much they are willing to lend as credit).

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\(^9\) *See*, e.g., *Harry Hoffman*, P-H Tax Ct. Mem. ¶ 67,158 (withdrawals held loans).

\(^9\) 322 F.2d 956 (9th Cir. 1963).
year period. The *Tollefsen* case also emphasized that the credits, treated on the corporation's books as repayments, were unimpressive in light of the much larger net amounts withdrawn. This factor, coupled with a pattern of steadily increasing debit balances, forms a *leitmotiv* running through many of the cases in this area. Consequently, courts confronted with this pattern frequently conclude that the credits were designed to give the color of loans to the transaction, but that in substance the withdrawal is a dividend, albeit disguised.

Another important factor has been the full repayment of shareholder withdrawals in years prior to the tax years. For example, in *Edwards Motor Transit Co.*, over a period of ten years the shareholder had made a series of withdrawals each of which had been repaid in not more than two years, and at the beginning of the tax year in question there was no outstanding balance due the corporation from the taxpayer. The court found that this was strong evidence that the withdrawals were not intended as substitutes for conventional dividend distributions. On the other hand, although withdrawals made on two different occasions in one year were, in each instance, repaid within a month, and the taxpayer's salary was annually credited to the account, the court in *William C. Baird* found these payments insufficient to counterbalance other strong indicia of an intentional distribution of corporate earnings, such as a steadily increasing debit balance over twenty years without any substantial repayment.

**AMOUNT OF DIVIDEND**

Once it is determined that the advance constitutes a constructive dividend despite repayment, the amount of the distribution which is taxable as a dividend turns upon two separate factors: the amount of the distribution, and available earnings and profits. The question which arises when considering both repayment and the amount of the distribution is

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94. See note 47 *supra* and accompanying text.
95. See, e.g., Regensburg v. Comm'r, 144 F.2d 41, 42-43 (2d Cir.), *cert. denied*, 323 U.S. 783 (1944); Livernois Trust v. Comm'r, Nos. 20141-43 (6th Cir., filed Oct. 12, 1970); Ben R. Meyer, 45 B.T.A. 228, 238 (1941).
99. See note 17 *supra*. The earnings and profits of a corporation are as a general rule reduced by the sum of (1) the amount of money, (2) principal amount of its obligations, and (3) the adjusted basis of other property distributed. IRC § 312 (a).
simply stated: should the amount of the withdrawal be reduced by repayments in the same or subsequent tax years? If the answer is no, the immediate question arises as to how the repayment should be treated. As to the remaining factor of earnings and profits, the crucial issue is not the effect of a repayment on the corporation’s earnings and profits but rather whether there is a duty of consistency on the part of the Service or the taxpayer to treat similar withdrawals in open years and years barred by the statute of limitations identically when the withdrawals in barred years, if dividends, would exhaust the earnings and profits account.

Net Withdrawal

Few decisions have explicitly evaluated the relationship between repayments and the amount of the distribution. Rather, the actual result in most cases varies with the position taken by the Commissioner in his determination of a deficiency in taxes and with the time of repayment. The majority of the decisions concluding that the advancement was in fact an intentional distribution of the corporation’s earnings simply held, without discussion of the point, that debits in excess of credits, i.e., the net amounts of the withdrawals, were constructive dividends where the Commissioner’s deficiency notice was based on a determination that the net distributions were dividends. Similarly, they have ruled that the entire amount was a dividend where his determination was that the entire amount constituted a dividend to the extent of earnings and profits.

100. The Internal Revenue Code provides with certain exceptions protective pre-requisites for assessment or collection by the Service of a deficiency (defined in IRC § 6211) in income, estate, and gift taxes: the Commissioner generally may not assess or collect a deficiency in such taxes until a deficiency notice (defined in IRC § 6212) has been sent to the taxpayer and for a 90-day period thereafter (if the taxpayer is in the United States), during which the taxpayer can file a petition with the Tax Court for a redetermination of the deficiency. If such a petition is filed, assessment usually must be further stayed until the decision of the Tax Court becomes final. For a more detailed discussion of these procedures see E. Goodrich, L. Redman, & J. Quiggle, Procedure Before the Internal Revenue Service 140-41, 208-9 (3rd ed. 1965).

101. See, e.g., George R. Tollefson, 52 T.C. 671, 678 (1969), aff’d, No. 34203 (2d Cir., filed June 19, 1970); William C. Baird, 25 T.C. 387, 393 (1955); Ben R. Meyer, 45 B.T.A. 228, 236 (1941). Indeed, one authority has flatly stated that “[i]n the common situation where the corporation and stockholder maintain a running account, the effect of repayments by the stockholder is that only the annual increase in the account balance is taxed...” 2 RABIN & JOHNSON, § 21.05 at 2146. Contra, 1 MERTENS, § 9.21 at 57 (“If the alleged loans are treated as dividends then the repayment of the loans will increase the basis of the taxpayer’s stock interest in the corporation.”).

The parameters of the problem are easily delineated. On the factual level, the following factors are significant: if there are no repayments in the tax year in question, in no case has any part of the withdrawal in that year been offset by repayments in a later year. In the vast majority of the cases involving a running account, the Service has determined the deficiency on a net withdrawal basis. In the handful of cases holding that the entire amount of the distribution constituted a constructive dividend there were either no repayments in the year in question, or unique facts were present—a fraud case with the strong implication that the repayment could be withdrawn again at will, and a case with a small cash repayment prior to audit made into an account, which unlike the typical open account had only two withdrawals. On the theoretical side, several basic points may be highlighted. Since the question of whether an advancement by a corporation is a dividend is determined by reference to the intent of the parties at the time of the withdrawal, any different intent manifested in a later year by repayment in such year cannot change the original intention and convert a dividend into a loan, or reduce the amount of the original dividend. Similarly, under an intent rationale, partial repayment in the year of disbursement cannot change what was intended as a distribution of corporate earnings into a loan, nor should it reduce the amount of the dividend. But, it frequently does.

Thus, it is abundantly clear that the results reached in many of the cases involving repayments in the year of the withdrawal cannot be justified by an intent rationale. However, the cases themselves fail to supply any other rationale. For example, in *Emma Farenga* the Commissioner determined that the amounts of the advancements to the tax-

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103. See, e.g., Atlanta Biltmore Hotel Corp., 349 F.2d 677 (5th Cir. 1965); Gurtman v. United States, 237 F. Supp. 533 (D.N.J.), aff'd, 353 F.2d 212 (3rd Cir. 1965) (per curiam); Ben R. Meyer, 45 B.T.A. 228 (1941).

104. See note 101 supra.


108. See note 18 supra and accompanying text.

109. See Atlanta Biltmore Hotel Corp. v. Comm'r, 349 F.2d 677 (5th Cir. 1965); Carlos Marcello, P-H Tax Ct. Mem. ¶ 69,193, appeal docketed, No. — (5th Cir. 1970).

110. See note 103 supra and accompanying text.

111. See note 101 supra.

payer which were to be considered dividends were not the net amounts but the entire amount less credits for the taxpayer's salary which had been "repaid" to the corporation. He refused to acknowledge credits for a cash repayment, a formal dividend, and reimbursement for entertainment expenses. The court in holding that only the net annual withdrawals constituted dividends, stated that the Commissioner's justification of his actions in refusing to recognize these credits is without validity and is inconsistent with his contention and our conclusion that the advancements made by the corporation to the individual stockholders were dividends and not loans.

The court did not disclose what the Commissioner's justification was, nor what its own justification was.

An analysis of several cases, where the courts turned to local law in ascertaining the year to which the repayment should be credited as if there were a repayment of a bona fide loan in such year, indicates that two incompatible concepts have been wedded: treatment of the withdrawal as a dividend and treatment of the repayment as if it were made in payment of a bona fide loan. This marriage of convenience arises, no doubt, from an equitable feeling that the taxpayer only had economic use of the net amount. In any event, H. L. Gumbiner enunciated the rule that where payments are made without designation of the advances against which they were to be applied, they are to be first credited to withdrawals made prior to the tax year. The court in A. F. Lowes Lumber Co. recognized still another approach: application of the credits first to the withdrawals made in the same year and any excess against withdrawals in years prior to the tax year. Not surprisingly, where the deficiency notice was computed on the premise that repayments during the tax year were to be applied against distributions made in that year, the court in A. John Cohen held that the net withdrawal of funds by the taxpayer in each of the taxable years was a distribution of earnings


114. P-H Tax Ct. Mem. ¶ 46,299. Similarly in Continental Machine & Tool Corp., P-H Tax Ct. Mem. ¶ 62,096, the taxpayer's president testified that he didn't know which notes the payments would apply to but he guessed to the earlier ones. Accordingly, the Tax Court held that since the record failed to show that any specific payment or credit was applied to any particular note it regarded the payments as having been applied to the oldest withdrawals first.


and profits. No case has attempted to reconcile or even acknowledge the existence of the other diverse approaches. These examples, as well as the cases discussed above dealing with net withdrawals and repayments in the same year, show the need for a precise rationale, rather than an attempt to force the results into a mold based solely upon the intent of the parties at the time of the withdrawal.

One possible rationale is that where the repayments consist of credits for salary, bonuses, or formal dividends, such amounts were in substance included in the original withdrawal, and their later “payment” to the shareholder and simultaneous offset or credit against the open account were mere bookkeeping entries. Following this reasoning, if compensation or dividends shown in the entries were reported as income to the shareholder, a net approach would have to be taken as to the original advancement to avoid the same amount being taxed once to the shareholder as part of a constructive dividend and again as compensation, etc. This rationale falls short in that it cannot account for an actual cash repayment in the year of the withdrawal, a not infrequent occurrence.

There exists yet another possible theory for rationalizing the net approach taken with repayments in the year of withdrawal, one derived, it is true, from the probable intent of the parties. Where repayments are made in the same year in order to give the color of a loan to the transaction, the parties may have had the intention at the time of the withdrawal that a portion of the advance was to be repaid for protective coloration—in short the taxpayer always intended to repay just that portion in order to obtain tax free treatment of the remainder. While this is, in all probability, what actually occurs in many cases, to advance this contention would be suicidal since it would be an admission of tax fraud.

117. For example, in Fender Sales, Inc., P-H Tax Ct. Mem. ¶ 63,119, modified on other grounds, 339 F.2d 924 (9th Cir. 1964), cert. denied, 382 U.S. 813 (1965) the credit entries consisted of salary, bonus, and rental payments returned to the corporation, and the taxpayer reported the returned bonuses as income.


119. See note 77 supra and accompanying text.

120. Cf. Freibro Corp. v. Comm’r, 315 F.2d 784, 787 (2d Cir. 1963) (withdrawal and partial repayment simultaneous, court accepted taxpayer’s contention that only net amount constituted dividend).

121. Not only does fraud—a wilful attempt in any manner to evade or defeat any tax—carry with it the risk of the criminal sanctions provided by IRC § 7201, but also
The soundest justification for the net approach when the repayment is made in the same year as the withdrawal is to treat the whole transaction as constituting a relinquishment by the shareholder in the year of receipt of part of the constructive dividend which he had a right to receive, and an acceptance by the corporation of such relinquishment. The rationale underlying the net approach can best be understood against the background of the "claim of right" doctrine (income must be reported in the year in which it is received under a claim of right, without restriction as to its use, rather than in a later year in which final determination is made of the right to retain it; and any repayment if any part of an underpayment of tax is due to fraud, a mandatory civil penalty equal to 50% of the underpayment is provided for in IRC § 6653(b).  

122. See, e.g., Fender Sales, Inc., P-H Tax Ct. Mem. ¶ 63,119, modified on other grounds, 339 F.2d 924 (9th Cir. 1964), cert. denied, 382 U.S. 813 (1965) and cases cited therein.


125. See notes 123 and 124 supra.


127. If a taxpayer receives income under a claim of right and without restrictions as to its use, it is taxable in the year of receipt, even though it may still be claimed that he is not entitled to retain the money, and even though he may be later adjudged liable to restore its equivalent. North American Oil Consolidated v. Burnet, 286 U.S. 417 (1932). The doctrine applies to both cash and accrual basis taxpayers; however, although an accrual basis taxpayer is entitled to deduct amounts repaid in the year in which the liability becomes fixed, repayments are deductible by a cash basis taxpayer only in the year made. 2 MERTENS § 12.103 at 401-02. Since this may not compensate adequately for the tax paid in the year of receipt either because of rate changes or more commonly because of the taxpayer's bracket changes, IRC § 1341 provides that (if the repayment exceeds $3,000) the taxpayer must recompute his tax in the year of repayment under either of the two following methods, whichever results in the lesser tax: (a) taking the repayment as a deduction, or (b) taking no deduction but reducing tax for the year of repayment by the amount of tax for the previous year attributable to inclusion of the amount repaid.

The claim of right doctrine is to be distinguished from the doctrine of constructive receipt—in simplest terms the former is concerned with when income admittedly re-
after the year of receipt must be taken as a deduction in the year of such repayment) which is predicated essentially on the practical requirement that taxpayers report their income on the basis of annual accounting periods. Accordingly, the claim of right doctrine, including the deduction limitation, is not extended to the situation where repayment is made within the same annual accounting period that the income was received, since the same policies, derived primarily from the annual accounting period concept, do not apply, and only the net amount of income is required to be reported.

No doubt because the deduction for repayments under both the net approach and the claim of right doctrine frequently arose in common factual patterns, and the Service raised arguments derived from the claim of right doctrine in some of the leading cases in this area, the net approach has been colored strongly by the claim of right doctrine. For example, since a requirement under the latter doctrine for allowing a deduction for repayment in a later year has been a mistaken claim as to ownership of the income, one line of cases growing out of United States v. Merrill permits an adjustment in the year of the advance where the taxpayer discovers that the income was mistakenly received and repays it in the year of such receipt. Another requirement of the claim of right doctrine is an obligation to repay the monies refunded.

129. United States v. Lesoine, 203 F.2d 123, 126 (9th Cir. 1953); J. W. Gaddy, 38 T.C. 943, 949 (1962), aff’d in part and rev’d in part, 344 F.2d 460 (5th Cir. 1965).
130. United States v. Merrill, 211 F.2d 297, 304 (9th Cir. 1954).
131. United States v. Merrill, 211 F.2d 297 (9th Cir. 1954); accord, Charles Kay Bishop, 25 T.C. 969, 974 (1956).
132. See, e.g., Frelbro Corp. v. Comm’r, 315 F.2d 784 (2d Cir. 1963); United States v. Merrill, 211 F.2d 297 (9th Cir. 1954).
133. See, e.g., United States v. Lewis, 340 U.S. 590, 591 (1951); United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953).
134. 211 F.2d 297 (9th Cir. 1954).
135. See United States v. Simon, 281 F.2d 520, 525 (6th Cir. 1960); cf. Kappel v. United States, 281 F. Supp. 426, 432 (W.D. Pa. 1968); IRC § 1341. To invoke the claim of right doctrine the taxpayer must show that the payee could have legally compelled restoration of the amounts repaid. Ernest H. Berger, 37 T.C. 1026, 1029 (1962). However, the compulsion need not arise from a court judgment—all that is required is a clear showing under state statutes or decisions of the taxpayer’s liability to repay. Kappel v. United States, 281 F. Supp. 426 (W.D. Pa. 1968).
Consequently, an element of compulsion is also required in some of the decisions applying the net approach. Where repayment of the item of income is voluntary, e.g., not pursuant to a new agreement between the corporation and the taxpayer but by unilateral action by one of the parties to the transaction, the taxable income is not reduced.

Although no court has explicitly applied the "relinquishment and repayment within the same year" or net approach analysis to the problem of partial repayment of a dividend disguised as a loan, the Tax Court in *Fender Sales, Inc.* was faced with the issues of the effect of return of bonus payments in the year of receipt and whether corporate withdrawals constituted loans or taxable dividends. It held that a specific withdrawal debited to account A constituted a dividend, and dismissed the taxpayer's contention that repayments (consisting primarily of credits for returned salaries, etc.) to account B evidenced that the withdrawal was a true loan with the same relinquishment of rights language it had used in determining that the taxable amount of the bonus was the net amount. Furthermore, it is submitted that the relinquishment and repayment theory not only supports a net withdrawal treatment for the payments made in the year of withdrawal but also requires such treatment. This approach underscores the relative unimportance of credit-repayments discussed above. For such credits are as easily explained as relinquishment of salary, or even of a constructive dividend, as repayments of bona fide loans.

In extending this approach to the constructive dividend repayment area, it must be noted that although most courts permit the inclusion of the net amount only of salary, etc. in income, regardless of the reason for the return of a portion in the year of receipt, the strictest interpretation of compulsion in those decisions which do require the return to be involuntary is found in cases involving a voluntary return of items of income—such as a dividend to a corporation—in order to reduce the original recipient's taxable income. Whether the requirement of an obligation to repay should form the predicate for a net approach in the

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constructive dividend area must be considered in the light of the policy that "it is not given to the taxpayer to lift the federal tax-hand from income, which he has once received in absolute right, by an attempt thereafter to alter its legal status through modification of the agreement out of which it arose. . . ." This rationale, of course, does not speak to repayment in subsequent years—the claim of right doctrine or its statutory version, IRC § 1341, would apply there.

The starting point in applying the claim of right doctrine to repay-

143. See Soled, Reimbursement Agreements for Excessive Payments: Compensation and Other, N.Y.U. 26TH INST. ON FED. TAX. 1143, 1149 (1968):
An examination of the principal Supreme Court decisions will lead to the inescapable conclusions that the basis on which they allowed a deduction for the required restoration of an item which was included in income in a prior taxable period was the equitable consideration of making the taxpayer whole, tax-wise. While the exigencies of the taxing system require the reporting of income on an annual basis, when in a later period the item of income is required to be restored, fairness to the taxpayer dictates that he be allowed a deduction. It is apparent that the underlying purpose and philosophy of allowing a deduction for the restoration of an income item is based upon considerations of equity.

The enactment of Section 1341 is a logical extension of this approach, since it is designed to give the taxpayer a fairer measure of relief, in the light of any differences between the applicable rates of taxation in the years when first included in income and when later restored.

144. Leicht v. Comm'r, 137 F.2d 433, 435 (8th Cir. 1943).

145. The relevant provisions are contained in IRC § 1341(a) which states:
(a) General Rule—If—
(1) an item was included in gross income for a prior taxable year (or years) because it appeared that the taxpayer had an unrestricted right to such item;
(2) a deduction is allowable for the taxable year because it was established after the close of such prior taxable year (or years) that the taxpayer did not have an unrestricted right to such item or to a portion of such item; and
(3) the amount of such deduction exceeds $3,000, then the tax imposed by this chapter for the taxable year shall be the lesser of the following:
(4) the tax for the taxable year computed with such deduction; or
(5) an amount equal to—
(A) the tax for the taxable year computed without such deduction, minus
(B) the decrease in tax under this chapter (or the corresponding provisions of prior revenue laws) for the prior taxable year (or years) which would result solely from the exclusion of such item (or portion thereof) from gross income for such prior taxable year (or years).
For purposes of paragraph (5) (B), the corresponding provisions of the Internal Revenue Code of 1939 shall be chapter 1 of such code (other than subchapter E, relating to self-employment income) and subchapter E of chapter 2 of such code.
ments in years subsequent to the withdrawal of dividends disguised as loans is that to be deductible\textsuperscript{146} under it the amounts have to be refunded pursuant to an obligation to repay;\textsuperscript{147} and a voluntary agreement to repay is not considered such an obligation.\textsuperscript{148} It is very likely that repayments of constructive dividends by a shareholder would be considered voluntary payments and not deductible.\textsuperscript{149} It appears that a similar result would obtain under IRC § 1341. True, when IRC § 1341 was newly enacted there was discussion as to whether the requirement of IRC § 1341 (a) (2) (that the absence of an unrestricted right to an item of income be established after the close of the prior taxable year) could be satisfied by a voluntary agreement of the parties in a later year to restore the previous income item.\textsuperscript{150} However, the Service has since ruled that IRC § 1341 is not available where the repayment is voluntary---a conclusion also reached by several courts.\textsuperscript{152} Thus, it is clear that where the shareholder and corporation agree in a year subsequent to the year in which the withdrawal was made that part of the constructive dividend be returned by the shareholder, he will not be entitled to a deduction under the claim of right doctrine or under IRC § 1341.\textsuperscript{153}

\textsuperscript{146} Such repayments are deductible only in the year of repayment. See note 128 supra and accompanying text.

\textsuperscript{147} See note 136 supra.

\textsuperscript{148} See Soled, supra note 143, at 1145-47.


\textsuperscript{150} See Webster, supra note 126, at 394.

\textsuperscript{151} Rev. Rul. 62-14, 1962-1 CUM. BULL. 11.


\textsuperscript{153} Technically, no deduction is allowable under IRC § 1341, merely a computation of tax due, but the section is commonly said to authorize a deduction. See Soled, supra note 143, at 1149 n.20. For a taste of the intricacies involved in such computations see Henderschott, Restoration—Claim of Right—One Aspect of Section 1341, 48 TAXES 585 (1970).

In Anson Beaver, 55 T.C. 85, 91-92 (1970), the Tax Court rejected the taxpayer's contention that certain advances, made with the understanding that they would be satisfied by forgoing salary for future services, were loans from his employer by holding that they constituted compensation in the year of receipt for services to be rendered in the future. The Tax Court also pointed out that only when such services are not rendered did a debtor-creditor relationship requiring satisfaction by monetary payment arise, consequently later cash payments pursuant to such a subsequent monetary obligation did not affect the court's conclusion—it stated, however, that the taxpayer would be entitled to compensating adjustments in computing his tax liability for the subsequent
Further, as indicated above, treatment of the repayment as repayment of a loan is inconsistent with the determination that the withdrawal was a constructive dividend. Accordingly, it is submitted that the decisions in *H. L. Gumbiner* and *A. F. Lowes Lumber Co.* (which held, respectively, that repayments should be first credited to withdrawals made prior to the tax year, and that repayments should be credited first to withdrawals in the current year and then prior years) were incorrectly decided. In any event, under both the case law and the statutory versions of the claim of right doctrine, the taxpayer is entitled to a deduction only in the year of repayment. This is not to say that the transactions can under no circumstance be structured so as to obtain a deduction for repayment if the withdrawals are held to be dividends.

years in which the payments were made. Such repayments of advance salary pursuant to the subsequent monetary obligation are distinguishable from repayments by a shareholder of a constructive dividend pursuant to an agreement entered into in a year subsequent to the withdrawal, because in the former instance an implicit understanding exists from the beginning that if the services are not rendered the advance will be repaid.

While there is much authority for the proposition that a cash basis taxpayer is required by the claim of right doctrine to report pre-paid income in the year of receipt (and consequently is entitled to a deduction in the later year of repayment), *Booth Newspapers, Inc.*, 17 T.C. 294 (1951), aff'd, 201 F.2d 55 (6th Cir. 1952); Rev. Rul. 68-44, 1968-1 CUM. Bull. 191, the application of this doctrine to prepaid income has been criticized, particularly where the taxpayer is on the accrual basis of accounting (the Service has recently promulgated special rules with respect to pre-paid income of accrual basis taxpayers). *See generally* Sobeloff, *New Prepaid Income Rules: IRS Reversal of Position Will Aid Many Taxpayers*, 33 J. Taxation 194 (1970). *See Note, Accrual Method Accounting for Federal Tax Purposes: A Need for Stability in an Area of Confusion*, 48 VA. L. Rev. 731, 740-41 (1962); *Lister, The Use and Abuse of Pragmatism: The Judicial Doctrine of Claim of Right*, 21 Tax L. Rev. 263 (1966). Consequently, it may be significant that the Tax Court in *Beaver* cited only IRC § 61(a)(1) and a pre-claim of right case: the court may have been indicating that it considered compensation for future services to be encompassed by the term "compensation for services," IRC § 61(a)(1), without regard to the claim of right doctrine. If this is the case, however, it would seem that any "compensating adjustments" would not arise from application of the deduction aspect of the claim of right doctrine, but rather would be allowable as a business expense for an expenditure under an enforceable obligation—the subsequent reduction of the obligation to render services is a monetary obligation, *see notes 164 through infra and accompanying text—or even as a loss on a contract to render services, which would be deductible under IRC §§ 165(a) and (c)(1) as a loss incurred in a trade or business. *Cf. Astoria Marine Construction Co.*, P-H Tax Ct. Mem. ¶ 45,083. Thus, where a taxpayer has made repayments of advances in the form of credits for salary, he may be well advised to attempt to squeeze himself into the ambits of *Beaver* if the Service asserts that the advances were constructive dividends and that the taxpayer is not entitled to any deductions for payments in later years.

155. *Id.* ¶ 60,141.
An analogous problem has, until recently, generated much controversy—reimbursement agreements for excessive compensation payments. Under such agreements, an employee agrees to repay his employer, commonly a closely-held corporation controlled by the employee, amounts (usually compensation) received by him which are not allowed as income tax deductions to the employer. Such agreements were originally designed to meet the claim of right doctrine requirement of an obligation to repay the monies refunded, the Service and the Tax Court already having ruled that a voluntary repayment of disallowed portions of salary payments was not entitled to IRC § 1341 treatment. The Tax Court had also held, in George L. Blanton, that for IRC § 1341 to apply the "requisite lack of an unrestricted right to an income item permitting deduction must arise out of the circumstances, terms, and conditions of the original payment of such item to the taxpayer and not out of circumstances, terms, and conditions imposed upon such payment by reason of some subsequent agreement between payor and payee." Thus, payments pursuant to a reimbursement contract entered into in a later year would not come within IRC § 1341. The Treasury went even further and indicated that even a contemporaneous contract would not be sufficient, reasoning that

§ 1341 of the Code is not applicable when the taxpayer did, in fact, have an unrestricted right to receive the amount and where the obligation to repay arose as the result of subsequent events. If the instant taxpayers in a subsequent year should repay the disallowed amounts to the corporation, it will not be because it was established after the close of the prior taxable year in which the money was received that the taxpayers did not have an unrestricted right thereto in such prior year, but because a liability on their part has later accrued which does not in any way establish that they had no right to the money when received

An answer to the problem was provided in Vincent E. Oswald, where the Tax Court held that repayment pursuant to a reimbursement

156. See generally Oschatz, supra note 149; Soled, supra note 143, at 1145.
157. Any taxpayer, including a corporation, is allowed to deduct only a reasonable allowance for compensation. See note 7 supra.
158. See Soled, supra note 143, at 1145-47.
159. See note 151 supra.
161. 46 T.C. 527 (1966), aff'd, 379 F.2d 558 (5th Cir. 1967).
162. Id. at 530.
164. 49 T.C. 645 (1968).
by-law adopted prior to the salary payment qualified as a business de-
duction of the employee, because it was necessary in his business as an
officer of the corporation to abide by the corporate by-law.\textsuperscript{166} The
Service has acquiesced in \textit{Oswald}\textsuperscript{166} and, more significantly, announced
in Revenue Ruling 69-115\textsuperscript{167} that reimbursements by an employee to
an employer of non-deductible portions of his salary, pursuant to a
corporate resolution agreed to by the employee prior to receiving the
salary, are deductible by the employee under IRC § 162 as a business
expense deduction because they were made under a legal obligation
enforceable under applicable state law. However, in this same ruling the
Service reiterated its position that IRC § 1341 would not be available in
these circumstances. It is worth noting that the court in \textit{Oswald} ex-
pressly reserved opinion on this question.

Application of these developments to the repayment of dividends
disguised as loans produces some interesting results. If the "loan"
agreement itself, or any notes executed contemporaneously with the
withdrawal, could be considered a reimbursement agreement, then all
repayments would be deductible when made; however, the basic assump-
tion here is that the loan arrangement was not bona fide. Hence, any
loan agreement or notes would not be "a legal obligation enforceable
under applicable state law."\textsuperscript{168} On the other hand, based on Revenue
Ruling 69-115, the shareholder and the corporation could enter into an
agreement whereby the stockholders would reimburse the corporation
the full amount, not previously repaid, of any loans made to such
shareholder which shall be finally determined for federal income tax

\textsuperscript{166} \textit{Id.} at 649.

\textsuperscript{167} 1969 INT. REV. BULL. No. 11 at 9. \textit{See generally} Oschatz, \textit{supra} note 149, at 1156.

\textsuperscript{168} Rev. Rul. 69-115, 1969 INT. REV. BULL. No. 11 at 9. The discussion in the text
assumes that the principles underlying a reimbursement agreement for excessive compen-
sation apply equally to a reimbursement agreement for a constructive dividend.
Several commentators make such an assumption, Harley, \textit{Dealings between Closely
Held Corporations and their Shareholders}, 25 Tax L. Rev. 403, 427 (1970); Jenks, \textit{supra}
note 166, at 98, and the Tax Court has acknowledged the presence of a reimbursement
agreement with respect to constructive dividends arising from a bargain sale to the cor-
poration, but reserved ruling on whether the shareholders were entitled to a deduction
in the year of repayment because that year was not before it. A. A. Emmerson, 44 T.C.
86, 90 n. 1 (1965).
purposes to constitute dividends. Such an agreement would not cover
the payments prior to audit, but it is not apparent how such repay-
ments could be readily fit into the reimbursement mold. Assuming that
an agreement similar to the one described were in effect and repayments
were made pursuant to it, the question remains whether a different
result than that provided in the ruling and Oswald would obtain if the
reimbursement were made by a stockholder and consisted of a dividend
rather than excessive salary. The problem alluded to is the familiar
one of whether a shareholder's activities in furnishing management and
other services to his closely-held corporation constitute a trade or busi-
ness. This question has most frequently arisen in the context of whether
a loss on a loan made by a shareholder to his corporation is limited to
non-business bad debt treatment provided under IRC § 166(d).169
However, the Supreme Court, in the landmark case of Whipple v. Com-
misssioner,170 left open the possibility that a loan by a shareholder-em-
ployee could be shown to be necessary to keep his job or otherwise
proximately related to maintaining his trade or business as an employee.
Oswald held that abiding by a reimbursement by-law was necessary in
the taxpayer's business as an officer of the corporation.171 Thus, where
the stockholder is also an employee the fact that a corporate by-law
requires reimbursement of dividends under certain circumstances should
produce no different result than would obtain if excessive salary were the
subject of the by-law. Nevertheless, there is still a caveat. The Whipple
Court stated parenthetically that it might be difficult for a sole or domi-
nant stockholder to prove that a loan was necessary to keep his job,
and the Oswald court pointed out that the stock of the corporation in
question was widely held.

Rather than rely on the technique of repayments under a reimburse-
ment agreement to avoid double taxation, it may be possible to utilize

169. See D. HERWITZ, BUSINESS PLANNING 129-32 (1966). Under IRC § 166(d) a non-
business bad debt of a non-corporate taxpayer which becomes wholly worthless is
treated as a short term capital loss.

170. 373 U.S. 193 (1963). The proximate relationship test approved in Whipple is
also contained in Treas. Reg. § 1.166-5(b). However, much controversy as to whether
dominant, i.e., primary, or significant motivation, is the appropriate test for determining
the proximate relationship of the debt to the taxpayer's business. Compare Judge
Friendly's majority opinion in Weddle v. Comm'r, 325 F.2d 849 (2d Cir. 1963) with
Chief Judge Lumbard's concurring opinion in the same case. The majority's significant
motivation test has also been adopted by the Fifth Circuit. United States v. Generes,
427 F.2d 279 (5th Cir. 1970).

171. It is well established that a taxpayer's status as a corporate executive constitutes
a trade or business. Folker v. Johnson, 230 F.2d 906, 909 (2d Cir. 1956); see Noland
the claim of right doctrine or IRC § 1341 by resorting to a state court in order to satisfy the requirement of an "involuntary repayment." After audit, the corporation could obtain a state court decree holding that the distributions to the shareholder created an enforceable obligation to repay, and ordering repayment. Certainly such repayments would appear, at first blush, to come within the Service's requirement of payments under a "legal obligation enforceable under applicable state law." However, the full effect of the Supreme Court's opinion in the Bosch decision cannot yet be ascertained. The issue in Bosch was the "proper regard" to be given by a federal court in determining the federal estate tax marital deduction to a state court's construction of a will. It was held that, while lower court decrees were entitled to some weight, only the decision of the highest state court was controlling. The Court stressed that the Commissioner was not made a party to the state proceedings, and that its holding would avoid much of the uncertainty inherent in a non-adversary state court proceeding.

Although the issue of whether a repayment pursuant to a non-adversary lower court decree would, in view of Bosch, be an involuntary payment for the purposes of the claim of right doctrine has not yet arisen, it has been held that, even in the absence of collusion, the lower state court's conclusions as to the nature of the withdrawals could not be determinative of their nature for federal income tax purposes if the government was not a party to the proceeding. Even assuming a taxpayer could navigate through the as yet unchartered shoals created by Bosch, he would not necessarily reach a safe harbor. For there still is a risk that a state court would not find the distribution to be a loan.

It would appear doubtful that a taxpayer would be entitled to an IRC § 162 deduction for repayments pursuant to a reimbursement agreement of constructive dividends in years barred by the statute of limita-
tions which were never included in his income. For under the doctrine of quasi-estoppel, 177 discussed below, the taxpayer would probably be unable to obtain such deduction. Similarly, a court has refused to apply IRC § 1341 to a repayment where the taxpayer had not reported the withdrawal received under the claim of right, nor paid the tax due on it. 178 The rationale was that ordinarily amounts received under a claim of right must be included in income in the year of receipt, although repaid in a later year, and IRC § 1341 was designed to alleviate the harsh effect of this rule. Otherwise, as a practical matter, the effect would be the equivalent of a double deduction. The subsequent opinion of the Supreme Court in United States v. Skelly Oil Co. 179 confirms this result. There the taxpayer had taken a percentage depletion allowance on the amount restored in a later year, for which it claimed a "deduction" under IRC § 1341(a)(4) for the full amount restored. In reducing the deduction for the depletion taken in the prior year, the Court stated that the Code should not be interpreted to allow the practical equivalent of a double deduction. It extended the Arrowsmith 180 principle (a prior year may be examined to determine whether a repayment gives rise to a regular loss or a capital loss) to permit examination of a prior year to ascertain the amount of the repayment allowable as a loss. Accordingly, where the repayment is of amounts which were

177. See notes 227 and 228 infra and accompanying text.

178. See Maxwell v. United States, 334 F.2d 181 (5th Cir. 1964). This was the holding of the unreported district court decision; the fifth circuit affirmed on another ground, reserving the questions of whether inclusion in income or payment of taxes on the amounts, or either, are prerequisites for relief under IRC § 1341.

179. 394 U.S. 678 (1969). Although Skelly on its facts dealt with depletion, the Court's reasoning can be expected to be extended far beyond the facts before it. For example, in Mitchell v. Comm'r, 428 F.2d 259 (6th Cir. 1970), reversing 52 T.C. 170 (1969), the court read Arrowsmith and Skelly for the proposition that "when income is given up, which in its inception was taxed at reduced rates, the taxpayer is not permitted to enjoy preferred treatment twice by deducting in full the extra amount given up as an ordinary deduction." On the other hand, the underlying element in Arrowsmith had appeared to the Tax Court as "the existence of an integral relationship between two taxable transactions in separate years, so that the characterizations of the latter transaction by the earlier one is necessary in order to reflect the true taxable income of the taxpayer." 52 T.C. at 175. See also Note, Repayment of Insider Profit Yields Capital Loss: CA-6 Invokes Arrowsmith, 33 J. Taxation 207 (1970).

180. Arrowsmith v. Comm'r, 344 U.S. 6 (1952). In Arrowsmith the taxpayers had liquidated their corporation in a prior year realizing capital gain; in a later year as transferees of the corporation, they paid a judgment against the corporation claiming a deduction as an ordinary loss. The Court held that the earlier transaction, although in a closed year, had to be considered in order to classify the nature of the later loss—capital gains or ordinary income—because the two transactions were "directly related" and "tied together".
treated as non-taxable loans in closed years, no deduction would appear warranted under the claim of right doctrine or IRC § 1341.181

Treatment of Repayment If Withdrawal Is Not Reduced and There Is No Deduction for Repayments

Leaving the quagmires of whether a constructive dividend should be reduced for repayments made in the same year, and whether the shareholder is entitled to deductions for repayments in later years, the next question is how the repayments are to be treated if the amount is not reduced and no deduction is obtained. One commentator has stated that "if the alleged loans are treated as dividends then the repayment of the loans will increase the basis of the taxpayer’s stock interest in the corporation."182 This statement is subject, however, to two caveats: In the case relied upon, Republic Nat’l Bank of Dallas v. United States,183 it was stipulated that if the repayments were held to constitute dividends, the repayment constituted a contribution to capital and increased the basis of the stock by that sum. And in M. Jackson Crispin,184 the taxpayer contended that his advance to the corporation in the year following a withdrawal was a payment upon the “loan”. However, the court there held that the withdrawal was a dividend and the advance to the corporation in the following year was a loan to it. It is clear, therefore, that classification of the repayment will itself probably call into play the complicated stock versus debt issue which may arise whenever a shareholder makes an advance to a corporation.185 This is not a purely academic problem because, after the court holds that the original withdrawal constituted a constructive dividend, the taxpayer may attempt to recover the repayment from the corporation.186 If the re-

181. Moreover, it would appear that in view of the recent decision in Mitchell v. Comm’r, 428 F.2d 259 (6th Cir. 1970), no deduction would be allowed under these circumstances for a payment pursuant to a reimbursement agreement. There the taxpayer, an executive with General Motors, exercised options to purchase G.M. stock and in a later year due to the furor over “insider” profits made a payment to G.M. of the profit. The Tax Court allowed an ordinary trade or business expense (IRC § 162) on the grounds that the payment to G.M. was necessary to preserve the taxpayer’s business reputation. William L. Mitchell, 52 T.C. 170 (1969). The sixth circuit found this business purpose to be irrelevant in determining whether the tax benefit doctrine of Arrowsmith applied.

182. 1 MERTENS § 9.21 at 69.
184. 32 B.T.A. 151 (1935).
185. See generally BITTEN & EUSTICE, ch. 4.
186. See generally Nims, Minimizing Constructive Dividend Exposure, TUL. 16TH ANN. TAX INST. 259, 278 (1964).
payment is considered a loan, then upon return of the repayment the taxpayer may argue that it is a tax-free return of capital. If, on the other hand, the repayment is considered a contribution to capital, the recovery itself runs the substantial risk of being taxed as a dividend. The recovery of the repayment probably could not qualify as a redemption entitled to capital gains treatment because the taxpayer commonly owns all the stock (at least by attribution) in these cases, and the Supreme Court, in its recent opinion in *Davis*, has for all practical purposes abolished the “flexible net effect” test. This test had looked to the business purpose of the redemption in determining whether a redemption was “not essentially equivalent to a dividend” when it

187. See note 4 *supra.*

188. If a corporation acquires its stock from a shareholder in exchange for property—a redemption under IRC § 317(b)—and the transaction qualifies under either IRC § 302(b)(1), (2), (3), or (4), the redemption is treated as a distribution in part or full payment in exchange for the stock. In which case the provisions of Subchapters O and P of the Code will usually provide for capital gains treatment.


190. See *McAndrews, Supreme Court’s Davis Decision: Does It Do Away with the 302(b)(1) Redemption?*, 32 J. TAXATION 328, 329 (1970):

The First, Fifth, Eighth, Ninth and Tenth Circuits all had adopted various versions of a flexible net effect test pursuant to which the reasons underlying a redemption were accorded varying degrees of weight in determining whether, notwithstanding the net effect of a pro rata redemption, capital treatment was appropriate. These courts recognized as the primary exception to the net effect test, the presence of a business purpose for the redemption but, in addition, they might look at such factors as the amount and frequency of past dividends and the profitability of the corporation. Business purpose has been the factor always accorded the greatest emphasis; however, without such a purpose, the presence of other favorable factors has not been sufficient to overcome the net effect of a pro rata redemption.

The Supreme Court, however, held that “the business purpose of a transaction is irrelevant in determining dividend equivalence under § 302(b)(1)”. 397 U.S. 301. While it is arguable that the Court’s holding is limited to a pro rata redemption, and that the “flexible net effect” test may still be available where the redemption is non-pro rata (but not substantially disproportionate, see note 192 *infra*) it is highly unlikely that the case law will develop in that direction in the lower courts since the infrequent high Court tax decisions tend to be read very broadly.

191. IRC § 302(b)(1) provides that a redemption shall be considered as payment in exchange for stock if it is not essentially equivalent to a dividend. See generally *Bratke & Eustric* § 7.24. Under the “net effect” test, derived from this language, the Court hypothesizes a situation where the corporation did not redeem any stock, but instead declared a dividend in an amount equal to that actually distributed in exchange for the stock redeemed. Then the Court compares from the shareholder’s vantage point the “hypothetical” situation after the dividend with the situation after the actual redemption. The redemption is “essentially equivalent to a dividend” whenever the results (e.g., payments received and the pattern of stockholder control) from the hypothetical dividend
could not come within the various safe harbors of IRC §§ 302(b)(2) and (3).\textsuperscript{192}

Duty of Consistency and Earnings and Profits

Once it is determined that a withdrawal is a corporate distribution and not a loan, it is treated as a taxable dividend to the extent that it comes out of accumulated earnings and profits of the corporation or out of earnings and profits of the taxable year, which are reduced by distributions of property by the corporation with respect to its stock.\textsuperscript{193} Any excess above this amount is treated as a return of capital and applied against the adjusted basis of the stock, and any further excess above adjusted basis is in turn ordinarily taxed as capital gain.\textsuperscript{194}

An important consideration is that there is no statute of limitations on the effect of prior distributions on accumulated earnings and profits,\textsuperscript{195} but the statute of limitations, usually three years, generally does apply to constructive dividends which were not reported as income.\textsuperscript{196} Frequently, however, the unreported withdrawals are in excess of twenty-five percent of the amount of gross income reported on the return, in which case a six year limit applies;\textsuperscript{197} and in the very rare instance in which it is found that the distribution was not reported in a willful attempt to evade the tax no statute of limitations applies.\textsuperscript{198} The problem here, of course, is the effect of withdrawals in closed years on the accumulated earnings and profits in a taxable year in which a later, similar advance to the taxpayer is made. If the Commissioner asserts that the distributions in the open years are, in substance, dividends, must he

and the actual redemption are the same. Ballenger v. United States, 301 F.2d 192, 196 (4th Cir. 1962).

\textsuperscript{192} These two provisions provide mechanical tests of “substantially disproportionate redemptions”, IRC § 302(b)(2), and “termination of the shareholder’s entire interest”, IRC § 302(b)(3); if the taxpayer meets either test, he will obtain the coveted capital gains treatment. See generally Bittker & Eustice §§ 7.22, 7.23.

\textsuperscript{193} See IRC § 301(c)(1) and note 99 supra.

\textsuperscript{194} IRC §§ 301(c)(2), (3).

\textsuperscript{195} See Bittker & Eustice 153 n. 11; Korbel, Recent Developments in the Earnings and Profits Area: “Past Errors and Deficit Carryovers”, 43 Taxes 494, 495-96 (1965).

\textsuperscript{196} IRC § 6501(a).


\textsuperscript{198} IRC § 6501(c)(2). See Grant Foster, P-H Tax Ct. Mem. ¶ 65,246.
treat those in closed years in the same manner, or may the taxpayer now raise the claim that they were dividends if the Service does not treat all withdrawals consistently? A similar problem may arise when a corporation cancels an open account in which most of the advances were made in barred years, or where the corporation is liquidated and a note representing an obligation to repay such an account is distributed. Since cancellation of a bona fide debt or its distribution in liquidation creates a constructive or liquidating dividend, in a reversal of roles, the taxpayer's position is that the withdrawals were dividends in the earlier years, while the Commissioner's is that the withdrawals were loans and therefore constitute a constructive or liquidating dividend in the year of cancellation or distribution.

The Tax Court's opinion in John Hamilton Perkins suggests a possible solution to the problem of inconsistent treatment in a prior year. There the taxpayer treated a disbursement in 1949 as a non-taxable loan, but did not include any of the withdrawal as income in 1951 when his note for the amount withdrawn was distributed to him in liquidation of the corporation. The government proceeded against the taxpayer when both 1949 and 1951 were still open, claiming that the 1949 transaction constituted a dividend (the 1949 transaction would be taxable at ordinary income rates, the 1951 transaction at capital gains rates). By the time the Tax Court had rejected the Commissioner's assertion that the 1949 transaction was taxable, the statute of limitations had run on the 1951 transaction. The Service then successfully invoked relief under IRC §§ 1311-15, "Mitigation of Effect of Limitations and Other Provisions," so as to include the note in the taxpayer's income for 1951, although, but for these Code sections, 1951 was then barred.

The provisions for the mitigation of the statute of limitations are available if the following elements are present: (1) a "determination".  

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203. The party seeking an adjustment under these provisions must plead and prove his right to such an adjustment. Roscoe Lilly, P-H Tax Ct. Mem. ¶ 36,207.
204. IRC § 1313(a). A determination means (A) a final decision of a court of competent jurisdiction, (B) a closing agreement under IRC § 7121 (a closing agreement can cover both the taxpayer in the year in which the determination is made and in the year which is "opened" by these provisions, Treas. Reg. § 1.1314(c)-1(e), (C) a final disposi-
which establishes that the prior treatment was erroneous; the adjustment or correction is to be made in the tax of a taxpayer who was a party or related to a party to the prior erroneous treatment; (3) the correction involves one of the seven "circumstances of adjustment" described in § 1312; and (4) the correction is either unfavorable to a party who has maintained a position inconsistent with the erroneous treatment, which position is adopted in a determination made by the Commissioner of a refund claim, and (D) an agreement under IRC § 1313(a)(4).

205. IRC § 1312 sets forth seven circumstances under which the adjustment provided by IRC § 1311 is authorized (see note 206 infra); these circumstances speak to a determination which requires certain treatment as to an item of income, deduction or credit, an inclusion, or as to the basis of property which was erroneously treated in another taxable year or in respect of a related taxpayer; however, the Code does not speak of erroneous treatment in the subsection dealing with double exclusion of an item of gross income which was not included in income by the taxpayer (the circumstances present in Perkins). IRC § 1312(3)(B).

206. The procedure for adjustment is as follows: the tax previously determined for the year of error is ascertained, IRC § 1314(a)(1); then the increase or decrease resulting from correction of the error is computed—this is the amount of the adjustment, IRC § 1314(a)(2)—and any increase in tax is treated as a deficiency in tax determined by the Commissioner to be assessed and collected under the law and regulations applicable to the assessment and collection of deficiencies, Treas. Reg. § 1.1314(b)-1(a), (see note 100 supra for procedure followed in the assessment of deficiencies) and any decrease in tax is treated as an overpayment with respect to the taxpayer as to whom the error was made and for the taxable year or years for which the adjustment was made, but the government or the taxpayer has only one year from the determination to receive such amount. IRC § 1314(b); Treas. Reg. § 1.1314(b)-1(a).

207. The determination may be with respect to any tax imposed by subtitle A (income taxes), Treas. Reg. § 1.1311(a)-2(b); these provisions are expressly made inapplicable with respect to excise taxes. IRC § 1314(e).

208. Again this limitation arises from the provisions as to circumstances of change contained in IRC § 1312.

209. (1) double inclusion of an item of gross income, (2) double allowance of a deduction or credit, (3) double exclusion of an item of gross income, (4) double disallowance of a deduction or credit, (5) correlative deductions and inclusions for trusts or estates and legateses, beneficiaries, or heirs, (6) correlative deductions and credits for certain related corporations, and (7) basis of property after erroneous treatment of a prior transaction.

210. IRC § 1311(b)(1). "[A] position successfully maintained with respect to the taxable year of the determination must be inconsistent with the treatment accorded an item which was the subject of an error in the computation of the tax for the closed taxable year". Treas. Reg. § 1.1311(b)-1(a). Specifically excluded from the requirement of maintenance of an inconsistent position are 1312(3)(B) (double exclusion of an item of gross income of an item not included in a return) and 1312(4) (double disallowance of a deduction or credit). Treas. Reg. § 1.1311(a)-1(c). A conflict has developed as to whether the term "inconsistent position" requires active inconsistency. Compare Comm't v. Estate of Weinrich, 316 F.2d 97 (9th Cir. 1963) with Yagoda v. Comm't, 331 F.2d 485 (2d Cir.), cert. denied, 379 U.S. 842 (1964). Similarly, the cases are in con-
when correction of the effect of the erroneous treatment was barred by
the statute of limitations,\textsuperscript{212} or, if the circumstances of adjustment in-
volve a double exclusion of an item of gross income which was never in-
cluded on a return of the taxpayer,\textsuperscript{213} the correction of the erroneous
treatment was \textit{not} barred when the Commissioner first asserted, in a de-
ficiency notice,\textsuperscript{214} that the item should be included in the taxpayer's
gross income for the year to which the determination relates.\textsuperscript{215}

The principal problem in application of IRC §§ 1311-15 has been
certaining what constitutes an item of income.\textsuperscript{216} The term has been
broadly construed "to include any item or amount which affects gross
income in more than one year, and produces, as a result, double taxation,
double deduction, or inequitable avoidance of the tax."\textsuperscript{217} In \textit{Perkins}
the Tax Court treated the loan and liquidating dividend transactions as
constituting the double exclusion of the same item of income—the loan
proceeds had been determined to be non-taxable in 1949 (and thereby
excluded); the liquidating dividend, \textit{i.e.}, the distribution of a note calling

\textsuperscript{211} IRC § 1311(b). Treas. Reg. § 1.1311(b)-1(a). It has been held that the party's
position is adopted only if the court making the determination not only grants the
result urged but also adopts the party's general theory as a basis for this result. Karpe
v. United States, 335 F.2d 454 (Ct. Cl. 1964).

\textsuperscript{212} IRC § 1311(a). The statute refers to a correction which is prevented by the op-
eration of any law or rule of law other than IRC §§ 1311-15 and 7122; the regulations
specify the various tax statutes of limitations and rules of law such as res judicata or
estoppel as provisions preventing such corrections. Treas. Reg. § 1.1311(a)-2(a).

\textsuperscript{213} IRC § 1312(3)(B).

\textsuperscript{214} For a brief discussion of the role performed by a deficiency notice in tax pro-
cedure see note 100 \textit{supra}.

\textsuperscript{215} IRC § 1311(b)(2)(A) requires that for these provisions to apply to a 1312(3)(B)
determination, assessment of a deficiency \textit{i.e.}, correction of the effects of the erroneous
be must not have been barred when the Commissioner proceeded against the
determination year; IRC § 1311(b)(1) specifically excepts a 1312(3)(B) circumstance
of adjustment from the requirement of maintaining an inconsistent position. The prob-
able reason for the first requirement is that without it the Commissioner could "by mak-
ing a groundless claim that an item of gross income should be included in income for the
current year and then losing his case in the Tax Court, secure a determination that
would permit him to assess a deficiency for a year otherwise barred at the time the
claim with respect to the current year was first asserted". 2 MERTENS § 14.08 at 38.
Similar provisions exist with respect to 1312(4), double disallowance of a deduction or
credit.

\textsuperscript{216} See M. GERSON, \textbf{STATUTE OF LIMITATIONS—MITIGATION}, A-16 (Tax Management
Portfolio # 110, 1965).

\textsuperscript{217} Estate of Gill v. Comm'r, 306 F.2d 902, 906 (5th Cir. 1962).
for the repayment of the loan, was includible in another taxable year (1951) but was not included in the taxpayer's 1949 or 1951 returns. Under this expansive reading of "item", a disguised dividend, unreported in a prior year, through its reduction of the earnings and profits account would appear to be such an item, since it affects gross income in more than one year and produces an inequitable avoidance of tax. Accordingly, if both the year of the withdrawal and the year of the liquidating or other dividend are open at the time the Commissioner first issues a deficiency notice as to one of the transactions, he can, for one year after a court's determination that he chose the wrong year, invoke IRC §§ 1311 through 1315 to attack the transaction in the other year—he has two bites at the apple.

However, in most instances both years will not be open and these provisions will not be available. They were enacted because attempts to place items of income and deductions in the proper year which was open were frequently thwarted by judicial reliance on estoppel, the duty of consistency (quasi-estoppel), or similar doctrines, lest the taxpayer or the Service, who might have already received a tax benefit in a closed year, obtain the practical effect of a double deduction. Both these doctrines and the mitigation of the bar of the statute of limitations are intended to take the profit out of inconsistency. Accordingly, where a prior withdrawal in a closed year, and a subsequent transaction in an open year, fall without the language of the statute, courts may be expected to resort to estoppel or quasi-estoppel.

The traditional elements of estoppel are as follows: (1) conduct amounting to a knowing misrepresentation of a material fact, (2) ab-

218. John Hamilton Perkins, 36 T.C. 313, 323 (1961); IRC § 1312 (3) (B).
219. See note 217 supra and accompanying text.
220. See note 215 supra and accompanying text.
221 See note 206 supra.
223. See Lyeth, Jr. v. Hoey, 112 F.2d 4 (2d Cir. 1940) (dissenting opinion). See generally 2 MERTENS § 14.22 at 82.
224. Compare the general requirement under IRC §§ 1311-15 of the maintenance of an inconsistent position with the duty of consistency discussed at notes 227 through 229 infra and accompanying text.
225. 2 MERTENS § 14.22 at 82-83. The Court of Claims has held that the doctrine of equitable recoupment is superseded by IRC §§ 1311-15 where the latter is applicable, Gooding v. United States, 326 F.2d 988 (Cl. Ct. 1964), and it has been suggested that this should also be the case with respect to estoppel. Note, Sections 1311-15 of the Internal Revenue Code: Some Problems in Administration, 72 Harv. L. Rev. 1536, 1537 n.8 (1959).
sense of knowledge to the contrary by the party claiming the benefit of the doctrine, (3) expectation by the party estopped that such conduct will be relied upon by the other party, (4) reasonable and actual reliance upon the conduct, and (5) detriment to the party relying.226

Where all the technical elements of estoppel are not present, particularly where reliance is not based on a misrepresentation, innocent or otherwise, the doctrine of quasi-estoppel—also known as the “duty of consistency”—has frequently been invoked in tax cases.227

[A] taxpayer may not, after taking a position in one year to his advantage and after correction for that year is barred, shift to a contrary position touching the same fact or transaction. When such a fact or transaction is projected in its tax consequences into another year there is a duty of consistency on both the taxpayer and the Commissioner with regard to it, whether or not there be present all the technical elements of an estoppel. . . .228

Both the doctrine of duty of consistency and IRC §§ 1311-15 must be affirmatively pleaded, and the burden of proof rests on the party asserting estoppel.229 Consequently, there are a number of cases where the parties raised neither and the court determined the character of a liquidating distribution in the light of prior withdrawals in barred years, or considered the effect of such withdrawals on the corporation's earnings and profits account without overt consideration of the duty of consistency, either in statutory form or quasi-estoppel.230 The results vary, dependent upon whether the issue before the court involved liquidating dividends, or the effect of prior disbursements on earnings and profits. In the context of liquidating dividends, courts have been reluctant to uphold the taxpayer's inconsistent position, and almost invariably have held that the withdrawals were loans,231 even where the taxpayer filed

226. 10 MERTENS § 60.02.
228. Orange Securities Corp. v. Comm'r, 131 F.2d 662, 663 (5th Cir. 1942). Commentators have pointed out, however, that the government is more successful than taxpayers in invoking this and similar doctrines. See, e.g., Lynn & Gerson, Quasi-Estoppel and Abuse of Discretion as Applied against the United States in Federal Tax Controversies, 19 TAX L. REV. 487, 489-90 (1964). A clear example of the dual standard may be seen by comparing Elizabeth Lewis Saigh, 36 T.C. 395, 422-24 (1961) with Irving Bartel, 54 T.C. 25 (1970).
229. See Alfred Fortungo, 41 T.C. 316, 323 (1963), aff'd, 353 F.2d 429 (3rd Cir. 1965) (estoppel); Roscoe Lilly, P-H Tax Ct. Mem. ¶ 56,207 (IRC § 1311 adjustment).
230. See notes 235 through 239 infra.
231. See generally 1 MERTENS § 9.21 n.41.
amended returns for the prior years and included as dividend income the amounts withdrawn, paying additional taxes thereon.\textsuperscript{232}

On the other hand, in several cases involving running open accounts, the Internal Revenue Service has less successfully argued that withdrawals from the account prior to the tax years—which if treated as dividends would have exhausted the corporation's accumulated earnings and profits—were loans, but withdrawals from the account in the taxable years were constructive dividends.\textsuperscript{233} The usual result of this inconsistency has been for the court to find that all of the withdrawals were loans.\textsuperscript{234} Perhaps it is significant that in two leading cases so holding, Rollin C. Reynolds\textsuperscript{235} and Victor Shaken,\textsuperscript{236} there were no current earnings and profits so that if the earlier withdrawals were dividends the withdrawals in the taxable years would be tax-free or taxed at capital gains rates.\textsuperscript{237} Thus, the judges could, without changing the tax results in the cases before them,\textsuperscript{238} avoid holding that withdrawals in open and barred years had to be treated similarly by the Commissioner through the simple expedient of concluding that the withdrawals in the open years were non-taxable loans. However, that tack would not work in \textit{H. L. Gumbiner},\textsuperscript{239} for there, although the withdrawals in closed years if considered disguised dividends exhausted the accumulated earnings and profits, there were some current earnings. The Tax Court held that the advances during the taxable years as well as during the closed years were a distribution of dividends to the extent of earnings available therefor. The taxpayer had pointed out that all of the withdrawals were of the same character, and he argued that the Commissioner should be consistent.

\textsuperscript{233} See \textit{Victor Shaken}, 21 T.C. 785 (1954); Rollin C. Reynolds, 44 B.T.A. 342 (1941). \textit{See also} Estate of Helene Simmons, 26 T.C. 409 (1956).
\textsuperscript{234} Id. Another approach was taken in the district court in \textit{Chapman v. United States}, 26 Am. Fed. Tax R.2d \$ 70-5086, 70-2 U.S. Tax Cas. \$ 9563 (C.D. Cal. 1970), where it responded to the posture of the Commissioner that delivery of $504,000 by a savings and loan constituted income to the taxpayer but that the taxpayer's return of $43,785 in the same tax year did not constitute an offset. The holding was that the $43,785 constituted deductible interest repayments or in the alternative was deductible as part of the same transaction as the receipt of the $504,000 (the unarticulated rationale apparently being that if this amount were income a net withdrawal approach should apply).
\textsuperscript{235} 44 B.T.A. 342 (1941).
\textsuperscript{236} 21 T.C. 785 (1954).
\textsuperscript{237} \textit{See} note 194 \textit{supra} and accompanying text.
\textsuperscript{238} This statement is based on the assumption that the amount of withdrawals in the open years was not in excess of the taxpayer's basis in his stock.
\textsuperscript{239} P-H Tax Ct. Mem. \$ 42,299.
Where the estoppel argument has been raised and openly met by the courts, taxpayers have been less fortunate. Again the law is clearer with respect to liquidating dividends. The recent Tax Court opinion in *Irving Bartel* highlights the equitable estoppel problems inherent in a corporate liquidation with an open loan account on its books. The open account in question was established in 1954 and the corporation was liquidated in 1964. The disbursements to the taxpayer totaled over $300,000, only $5,000 of which was repaid prior to 1958. In 1962, the Commissioner determined in his deficiency notice that the 1956 and 1957 withdrawals were in fact dividends. Although the taxpayer asserted in his petition that the 1956 and 1957 withdrawals were loans, the parties settled the case by agreeing to treat five-sixths of the net withdrawals in 1956 and 1957 as dividends. In the second case, involving 1964, the government argued that the withdrawals were in fact loans, but asserted in the alternative that having treated the distributions as loans in closed years the taxpayer was required to continue to treat them as loans for purposes of computing his gain on the liquidation of the corporation. The taxpayer asked the court to look behind the corporate books, on which the withdrawals were cast in the form of loans, and to examine all the circumstances leading to the conclusion that the distributions were in fact the payment of compensation or dividends. The court refused to do so and held that the disbursements were loans, without explicitly stating at this point that it was relying on the duty of consistency. The taxpayer also contended that the Commissioner had been inconsistent in determining that the 1956 and 1957 distributions were dividends but that prior and subsequent withdrawals were loans.


*See* note 100 *supra.*

*Id.*

Now the petitioner [taxpayer] asks us to look behind the form in which he cast these transactions to ascertain that they were in substance something different. . . . The effect of accepting his position would be to exempt the rest of the disbursements from taxation at any time—either when they were received, or at the time of the distribution [in liquidation] . . . . The respondent's [Commissioner's] position asks us to rely upon the objective record, but the petitioner would have us take a new look at all the old evidence. Under these circumstances, it seems that not only the equities but the practical administration of the law argue against granting the petitioner's request, and accordingly, we hold that the disbursements were loans.

*54 T.C.* at 31-32. Thus, it is clear that the court was implicitly holding the taxpayer to the duty of consistency; the Commissioner had in the alternative sought to invoke quasi-estoppel (which must be affirmatively pleaded, *see* note 229 *supra*).
The court as much as admitted this, but stated that any inconsistency on the government's part was not relevant—the Commissioner was not trying to tax the same transaction twice; the taxpayer was trying to avoid paying any tax at all on the withdrawals. The court's final words turned the taxpayer's own consistency argument against him: "We are of the opinion that the petitioners should continue to treat the advances . . . as loans, consistent with the manner of their treatment in the earlier years." 244

There have been only three cases, all decided in the same year, dealing directly with the question of whether earnings and profits can be recomputed to correct prior erroneous treatment of a distribution if it would result in the imposition of less-than-divided or no tax liability and the year of error is closed: Alderson v. Healy,245 Jacob M. Kaplan,246 and Gurtman v. United States.247 The district court in Alderson faced the issue of quasi-estoppel more squarely than the other two courts. There the taxpayers had treated the exchange of partnership assets for notes in a newly organized controlled corporation248 as a taxable event

244. 54 T.C. at 33.
246. 43 T.C. 580, 600 (1965).
248. "Controlled" is used in the technical sense of the taxpayers owning "immediately after the transfer stock possessing at least 80% of the total combined voting power of all classes of stock and at least 80% of the total number of shares of all other classes of stock of such corporation. . . ." Treas. Reg. § 1.351-1(a) (1). See IRC § 368(c). However, the term corporation is used advisedly. In fact, the taxpayers, a group of doctors, had transferred their interests in a medical partnership to an unincorporated "professional association" and were only able to establish that it should be treated as a corporation for tax purposes through litigation—the landmark Kintner v. United States, 216 F.2d 418 (9th Cir. 1954). For more recent developments on the professional corporation scene see Note, Professional Corporations: Analysis Under the Tax Reform Act and Survey of State Statutes, 58 Geo. L. J. 487 (1970); Note, Professional Associations and Corporations: Tax Considerations, 11 Wm. & Mary L. Rev. 685 (1970). However, even if the "professional association" had been treated as a partnership for income tax purposes—"for the purposes of [income taxation of partners and partnerships] . . ., the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization . . . which is not, within the meaning of this title [subtitle], a corporation or a trust or estate. . . ." IRC § 761(a). The transfer would have been tax-free under the partnership analogue of IRC § 351 (see note 250 infra), IRC § 721. Although, as a general rule, under IRC § 731(a)(1) a partnership distribution is not taxed as a dividend would be (see note 252 infra), this is largely because a partnership is by and large treated as a conduit with each partner liable for his distributive share (as determined by the partnership agreement, with certain significant exceptions, IRC § 704) of partnership income, whether distributed or not. IRC §§ 701, 702. Furthermore, even if the medical association were a Massachusetts or business trust and, therefore, taxable as a trust, see Fox, The Maximum Scope of the Association
and then reported payments on the notes as return of capital and capital gain income,²⁴⁰ both in closed years and in years before the court. The district court held that the exchange was tax-free,²⁵⁰ and that the notes constituted an equity interest²⁵¹ in the corporation, hence the payments were made with respect to stock and constituted dividends.²⁵² The taxpayers had made the alternative argument that if the payments were dividends, then the payments in closed years exhausted the corporation’s earnings and profits. It was held that

> [u]nder the doctrine of quasi-estoppel, plaintiffs will not be permitted to benefit by an inconsistent treatment of earnings and profits with respect to the period before 1955 as compared with the period from and after January 1, 1955. Having treated the pre-1955 payments as something other than dividends for income tax purposes in those years, plaintiffs may not now treat them as dividends solely to reduce earnings and profits available for distribution from and after January 1, 1955.²⁵³

The Tax Court has not clearly indicated that the duty of consistency is as determinative in the area of recomputation of earnings and profits

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²⁴⁰ Concept, 25 Tax L. Rev. 311, 322-23 (1970), distributions from it would be taxable to the beneficiaries-doctors to the extent of distributable net income (DNI), IRC §§ 643(a), 662, at ordinary income rates if it was ordinary income in the hands of the trust, IRC § 662(b). In addition, distributions of accumulated income which had been taxed to the trust, IRC § 641(a), would under the facts in Alderson be treated as if distributed and taxed to the beneficiaries in the year of accumulation with resulting increases in their tax liability even under pre-Tax Reform Act of 1969, IRC §§ 665, 666 (the “throw-back” rule). See generally R. Jackson, Subchapter J—Throwback Rules (Tax Management Portfolio #170, 1969). In short, the taxpayer’s treatment of the exchange was wrong under a corporate, partnership, or trust approach.

²⁴⁹ The taxpayers elected to report their “gain” on the installment method, which in effect allows each year’s payments to be prorated as a return of basis and gain, IRC § 453, Treas. Reg. § 1.453-1(b) (1), capital or ordinary as the case may be—if certain pre-requisites are met.

²⁵⁰ IRC § 351(a) generally provides for non-recognition of gain (or loss) upon the transfer by one or more persons of property to a corporation solely in exchange for stock or securities, if immediately after the exchange the transferor or transferors are in control (see note 248 supra) of the corporation. Treas. Reg. § 1.351-1(a) (1).

²⁵¹ This particular aspect of Alderson is but another instance of the familiar debt-equity controversy. See note 4 supra.

²⁵² A distribution of property by a corporation to a shareholder with respect to its stock is generally considered a dividend under IRC § 316. Treas. Reg. § 1.301-1(a). See note 17 supra.

as it is in the area of liquidating dividends.\textsuperscript{254} For in \textit{Jacob M. Kaplan},\textsuperscript{255} the Tax Court relied in part on the taxpayer’s failure to meet his burden of proof, and in part on an estoppel argument, in denying adjustments to the earnings and profits account for withdrawals in closed years. The taxpayer had suggested that if the court concluded that his withdrawals in the tax year were dividends then similar withdrawals in closed years should be similarly regarded. The court averred, stating that (1) the taxpayer had offered no evidence showing that he had no intent to repay the unpaid portions of the withdrawals when they were made,\textsuperscript{256} (2) these withdrawals were not reported as dividends, (3) no tax had been paid on them, and (4) the Service had not disturbed the taxpayer’s treatment when the years were open. The Tax Court concluded as follows:

\begin{quote}
The Commissioner did not disturb such treatment by petitioner, and the period within which he might have made any adjustment thereto has long since become barred by the statute of limitations. In these circumstances and in the absence of any evidence presented by petitioner that his prior representation and treatment were untrue or erroneous, we hold that the suggested adjustment is not allowable.\textsuperscript{257}
\end{quote}

Thus, it is not altogether certain that the Tax Court would accept an estoppel argument if the taxpayer showed that the withdrawals in closed years were dividends. On the other hand, it should be noted that such proof would tend to undermine the taxpayer’s contention that the withdrawals in open years were non-taxable loans.\textsuperscript{258}

\textit{Gurtman}\textsuperscript{259} rounds out the trilogy. On facts similar to those in \textit{Kaplan}, the taxpayer argued in the alternative that if advances during the tax years were dividends then withdrawals in closed years should be

\begin{itemize}
\item \textsuperscript{254} See Irving Bartel, 54 T.C. 25 (1970).
\item \textsuperscript{255} 43 T.C. 580 (1965).
\item \textsuperscript{256} In fact, the court made extensive findings with respect to these prior withdrawals, which were clearly sufficient to support an ultimate finding of fact that they were indeed constructive dividends. 43 T.C. at 582-83. To be contrasted is H. L. Gumbiner, P-H Tax Ct. Mem. ¶ 46,299, where the government also asserted that the taxpayer had made no showing as to the character of the withdrawals in the closed years. There the court found that the taxpayer had met his burden of proof by merely stating on cross-examination that all the withdrawals, including those in the barred years, were substantially the same.
\item \textsuperscript{257} 43 T.C. at 600.
\item \textsuperscript{258} Moreover, the “tax benefit” permutations of \textit{Skelly Oil} and \textit{Bartel} must also be considered. See notes 279, 280 infra and accompanying text.
\item \textsuperscript{259} 237 F. Supp. 533 (D.N.J.), aff’d, 353 F.2d 212 (3rd Cir. 1965) (per curiam).
\end{itemize}
similarly considered, with the result that the accumulated earnings and profits would be exhausted since there were only nominal earnings in the tax years. The district court rejected the taxpayer's contention stating that

this argument falls because it subsumes that the previous treatment of the withdrawals as loans precludes the proper taxation of withdrawals made in later years. Only the character of the payments that occurred during the . . . tax years is presently in issue, and the cumulative fact of non-repayment of the so-called loans in prior years may have been considered by the Commissioner in determining the status of the withdrawals during the years here in question. . . .

The court went on to hold that the Commissioner was not estopped by his failure to question withdrawals by the taxpayer in other tax years. Thus, it is readily apparent that the court misconstrued the taxpayer's alternative contention as a plea for it to estop the Commissioner from determining that the distributions in open years were dividends because he had not treated the prior withdrawals as dividends. It is true that an estoppel argument against the Service in these circumstances merits short shrift. "[R]egardless of whether the Commissioner had the opportunity to treat the withdrawals in both years in the same manner it is well established that the Commissioner is not subject to any estoppel or similar disability if he does not do so. . . . The mere fact that . . . [the taxpayers] may have obtained a windfall in 1960 does not entitle them to like treatment in 1961." The Commissioner's failure to assert a deficiency in a closed year is commonly analyzed as a mistake of law, and it is well established that a mistake of law is not a circumstance calling for the application of quasi-estoppel. The court in Gurtman, however, missed the thrust of the taxpayer's argument, which was that it may be necessary to examine closed years in order to determine the effect of a transaction on earnings and profits, and when doing so simi-

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260. Id. at 537.
262. See Automobile Club of Michigan v. Comm'r, 353 U.S. 180 (1957). The rubric of "mistake of law" has been extended quite liberally to preclude invoking the doctrine of estoppel against the government. For example, in Elizabeth Lewis Saigh, 36 T.C. 395, 422-24 (1961), the Service had asserted and collected a deficiency against the distributee for interest income on the withdrawal in a closed year, but in an open year determined that the withdrawal had been a dividend: "[I]n this case the transfer was a dividend, and respondent [the Commissioner] was duty bound so to treat it. He had
lar transactions should be treated similarly, i.e., because the Commissioner determined that the distributions in open years were dividends, he had to treat prior withdrawals as dividends for the purpose of recomputing earnings and profits. The first prong of this argument is well established—to determine the proper tax treatment of a transaction in the tax year it may be necessary to look to events that occurred in earlier years closed by the statute of limitations. If so, it is the court's "unavoidable duty to examine the circumstances occurring in the earlier closed years," 263 thereby refuting the Gurtman court's assumption that "[o]nly the character of the payments that occurred during the . . . tax years is presently in issue . . . ." 264 The second prong is, in effect, the duty of consistency restated. While it has been held that the duty of consistency applies to the government as well as the taxpayer, 265 it must be noted that the Commissioner's posture here does not fall squarely within the parameters of quasi-estoppel, i.e., taking a position in one year to his advantage and after correction for that year is barred, shifting to a contrary position touching the same transaction, 266 since his failure to object to the treatment of the distributions as nontaxable loans in closed years was to his disadvantage. It is highly unlikely that, where such inconsistency by the Service does not result in the same transaction being taxed twice, a court will impose a duty of consistency upon it. 267 Therefore, the crucial question is whether a taxpayer breaches his duty of consistency by maintaining in the alternative that all withdrawals should be treated similarly with a resulting recomputation of earnings and profits in a closed year, i.e., was the district court's invocation of estoppel in Alderson correct?

266. See note 228 supra and accompanying text.
267. See Irving Bartel, 54 T.C. 25 (1970): "However, whether or not his [the Commissioner's] positions are inconsistent is not material in this opinion. The respondent is not attempting to collect a tax twice on the same transaction, he is merely contending that the disbursements in some years constitute loans, while in effect admitting that the disbursements in other years were dividends . . . ."
It is clear that where the primary contention of the taxpayer is that the withdrawals which he previously treated as loans were in fact dividends, as in the liquidating dividend situation, he fits precisely within the ambit of the doctrine of quasi-estoppel. Thus, the court in Bartel correctly required the taxpayer to continue treating the advances as loans, consistent with the manner of his treatment in earlier years. The critical inquiry is whether a different result should obtain when the taxpayer in an alternative argument points out an inconsistency in the government's main position. While this aspect has not been discussed by courts considering the application of the duty of consistency in this area, it has frequently arisen in the context of whether a taxpayer has taken an "inconsistent position" for the purposes of IRC §§ 1311-15.\textsuperscript{268}

Here again, conflicting positions are staked out by the courts. The Tax Court has held that an alternative contention by the taxpayer is not an "inconsistent position."\textsuperscript{269} The Court of Claims has held to the contrary.\textsuperscript{270} It is submitted that the better approach is to distinguish between an alternative argument which itself asserts an inconsistent position and one which points out an inconsistency in the government's main position—only the former being a true inconsistent position.\textsuperscript{271} The test is:

If the Commissioner's position on the main question is logically consistent with a decision either way on the question raised by the alternative argument, then the taxpayers have maintained an inconsistent position. \textit{E.g.,} \textit{Cory v. Commissioner}, 29 T. C. 903 (1958). However, if taxpayers in making an alternative argument merely point out to the court that if it adopts the position on the

\textsuperscript{268} See notes 203 through 215 \textit{supra} and accompanying text for an outline of these provisions.

\textsuperscript{269} Estate of A. W. SoRelle, 31 T.C. 272, 275, 277-78 (1958). In the prior case in which the "determination" arose, the taxpayer had maintained its books on a hybrid method of accounting in which no inventories were kept for wheat. The taxpayer maintained that its book method of accounting should be cash basis; the Service, that the correct method was an accrual method with inventories of the wheat. The taxpayer argued in the alternative that if inventories were required it was entitled to an opening inventory for the wheat. The court in the prior determination agreed. Judge Raum, who decided the second \textit{SoRelle} case, later explained his decision as resting on the fact that "the requisite earlier determination there involved did not adopt a position maintained by the taxpayer with respect to whom it was made but, on the contrary, adopted a position at odds with the one maintained by the taxpayer." \textit{Elaine Yagoda}, 39 T.C. 170, 180 n.3 (1962), \textit{aff'd}, 331 F.2d 485 (2d Cir. 1964). Estate of Abraham Goldstein, P-H Tax Ct. Mem. ¶ 63,258, \textit{aff'd}, 340 F.2d 24 (2d Cir. 1965) followed \textit{SoRelle} on this point.

\textsuperscript{270} Dobson \textit{v. United States}, 330 F.2d 646 (Cl. Ct. 1964).

\textsuperscript{271} \textit{Id.} at 650-51 (Laramore, J., concurring).
main issue urged by the Commissioner, a consistent application of that position requires the adoption by the court of the taxpayers' alternative argument, then taxpayers have not maintained an inconsistent position but have merely pointed out an inconsistency in the Government's position. E.g., Heer-Andres Investment Co. v. Commissioner, 22 T. C. 385 (1954); Estate of Abraham Goldstein v. Commissioner, T. C. Memo 1963-258.272

Applying this analysis to the recomputation of earnings and profits and duty of consistency, it is evident that the taxpayer is not being inconsistent, but merely pointing out that there is no statute of limitations273 on computing earnings and profits, and that if the court adopts the government's main argument that the withdrawals in open years were dividends, similar withdrawals in closed years should be treated similarly for the purposes of determining the amount of the open withdrawals which constitute a dividend.274

A second factor which supports a different result in the liquidating dividend and recomputation of earnings and profits cases is that the Tax Court has indicated in E. D. Rivers, Jr.275 that, if the taxpayer continues to maintain only his position taken in the closed years, the doctrine of quasi-estoppel is inapplicable, but that the court on its own cognizance will apply the correct rule of law.276 Thus, reading Rivers together with

272. Id.
273. See note 195 supra and accompanying text.
274. Although by application of IRC §§ 1311-15 to the facts in the typical earnings and profits situation there would be no requirement of an inconsistent position, see notes 213 through 215 supra, this should not affect the validity of the analogy.
275. 49 T.C. 663, 667 (1968). Note that when the Commissioner proceeds on an incorrect theory the Tax Court must sustain the deficiency if it is supportable by any theory. Helvering v. Gowran, 302 U.S. 238 (1937). Since the foundation for this rule is the fact that the burden of proof is on the taxpayer, it is possible that the same result does not obtain whenever the taxpayer has a defense under a theory which is not raised. Id.
276. In Rivers the taxpayer, like the taxpayers in Alderson, made a transfer of assets to a controlled corporation under the predecessor to IRC § 351 receiving in return stock and notes or securities. The corporation made monthly payments on the notes. The taxpayer reported no income with respect to such payments during the open and closed years, based on the rationale that the corporation had a transferred basis on the assets (IRC § 362) which the court correctly treated as irrelevant to the question of whether the taxpayer realized any income on the payments. The court held that because the taxpayer's substituted basis in the notes (IRC § 358) was less than the amounts to be received, each principal payment in the open years was to be allocated in part to return of basis and in part to the receipt of income. The government maintained that under the duty of consistency the taxpayer should be forced to treat all payments in closed years as a return of basis with the result that by the tax years all of the taxpayer's basis
where the court, in the absence of an allegation of estoppel by the Commissioner, held that withdrawals in open and closed years were dividends, a taxpayer who has consistently maintained that the withdrawals were dividends would be in a better position (assuming the Alderson approach is correct)\(^{278}\) than the taxpayer who, represented by knowledgeable counsel, argued in the alternative that if the government's position were accepted all withdrawals should be treated similarly. Such a result is hardly consonant with the goals of our adversary system. With a liquidating dividend, however, if the taxpayer maintains his earlier position that the withdrawals were loans there will be no controversy because this is also the position of the Service.

It is submitted that due to the inconsistency inherent in the Commissioner's treatment of withdrawals in open years as dividends and those in closed years as loans for the recomputation of earnings and profits, the distinction between an inconsistent primary contention by the taxpayer that withdrawals treated by him as loans were in fact dividends, and an alternative argument bringing out the government's inconsistency, and the desirability of attaining symmetry between the case law development in this area and under IRC §§ 1311-15, the duty of consistency should not be invoked against the taxpayer here. However, it cannot be denied that under this approach the taxpayer will receive a tax benefit by the disappearance of earnings and profits which will forever escape dividend taxation. The Supreme Court's statement in *Skelly Oil* that "the Code should not be interpreted to allow respondent [the taxpayer] 'the practical equivalent of double deduction'"\(^{279}\) and the observation by the Tax Court in *Bartel* that the taxpayer was attempting to use the argument of inconsistency on the part of the government in order to avoid paying any tax on the withdrawals from the corporation\(^{280}\) indicate that it is probable that the duty of consistency, if invoked by the government, will be applied by the courts. In any event, the goal should be a decision on the question of recomputation of earnings and profits with full recognition and consideration given to all of the factors discussed above, rather than avoidance of the problem by a

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result-oriented holding that all the withdrawals were loans, or by holding against the taxpayer on the basis of failure to meet his burden of proof.

CONCLUSION

The prior discussion has focused on three questions. The first is the role that a repayment of a corporate distribution, cast in the form of a loan, plays in a judicial determination of whether such distribution constituted a loan or a dividend. At first blush, to state the issue seems to answer it since repayment of a dividend appears a contradiction in terms. However, this is not the case. A repayment is only the basis for an inference that the withdrawal was intended to be a loan and may be rebutted by other objective evidence indicating the absence of a creditor-debtor relationship. Furthermore, the repayment may be in substance a relinquishment of the right to a portion of the constructive dividend or a contribution to capital.

Since the guidelines, or better factual patterns, are established here (to the extent possible in any factual issue and in particular in the area of whether a debtor-creditor relationship exists), the principal benefit from an analysis of the factual patterns contained in the reported decisions lies in the field of tax-planning. Whether such planning will result in treatment of the withdrawals as loans by the Service or the courts depends to a large degree on the level at which tax advice is sought. A safe harbor in the planning stage can be reached by prompt repayment of the advance within one or two years—prior to any possible audit. If the client insists on maintaining an open account, however, he should at least consistently make substantial payments (preferably in cash) in the year of withdrawal and periodically balance the account. In short, shareholders may utilize their close corporations as a lenient banker or even as a device "to level out their taxable dividend income and achieve the lowest possible tax cost for that income while at the same time retaining considerable flexibility in the cash available to them individually in each year."

If they do not account to their cor-

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281. See notes 234 through 238 supra and accompanying text.
282. See Jacob M. Kaplan, 43 T.C. 580 (1965). As discussed in note 256 supra the taxpayer would appear to have in fact met his burden of proof.
284. The discussion in the text is based on the assumption that all of the formal indicia of a loan are present. See note 23 supra.
285. 1 MERTENS § 9.21 at 70.
poration for the withdrawals, they will in all likelihood ultimately ac-

count to the Internal Revenue Service. In addition, tax advice at this
stage may in effect insure against double taxation in the event the with-
drawal is finally determined to be a constructive dividend by suggesting
that an agreement calling for reimbursement of such amounts to the

corporation in that event be instituted prior to the disbursements.

At the post-audit stage, repayments where none have been made prior
to audit are less than helpful. However, a continuation or even an in-
crease in an existing pattern of repayments is advisable. This indicates
the necessity of a thorough investigation of prior withdrawals and re-
payments. A reimbursement plan put into effect after the distributions
have already been made will not be acceptable to the government, and for
that reason alone is not advisable.

The second issue dealt with the manner in which repayments should
be treated if the withdrawal was determined to constitute a dividend.
The cases in this area provide no definite answers. Consequently, in the
absence of a reimbursement agreement, the best strategy for avoiding
double taxation as to the repayments is to direct the attention of the
Service and the courts to the Code and case law development outside
this area. Where the repayment is in the same taxable year as the with-
drawal it should be treated as a relinquishment of the right to a portion
of the dividend, albeit constructive, with only the net amount of the
distribution being taxable in accordance with the treatment of relinquish-
ment in the taxable year of payment of the right to salary, bonus, or
rental payments. If the repayment was made in a subsequent year, at-
tempts to claim a deduction under the common law or statutory versions
of the claim of right doctrine or to obtain characterization as a loan
to the corporation (so that later recovery of such repayment would not
be a taxable event) are unlikely to be successful in the courts, but may
be useful bargaining points in negotiating a settlement with the Internal
Revenue Service. On the other hand, if a reimbursement agreement has
been inaugurated prior to the withdrawals such subsequent repayments
should constitute deductible business expenses under the rationale of
Oswald.

Although the third area discussed, application of the duty of consist-
tency to the recomputation of earnings and profits and to a liquidating
dividend, has been faced more squarely than treatment of repayments,
the alternatives which the taxpayer may pursue are even more restricted

46 T.C. 527, 530 (1966), aff'd, 379 F.2d 558 (5th Cir. 1967).
As to liquidating dividends, it is clear that the taxpayer is estopped from maintaining that the withdrawals which he treated in closed years as loans were in fact dividends. However, if the taxpayer enters into a closing agreement for open years with the Service, the latter might be willing to agree that the withdrawals in closed years were also dividends at not too great a tax cost, thereby avoiding the situation of the taxpayer in *Jacob M. Kaplan*.

Turning to the recomputation of earnings and profits, if the Service raises the issue first by claiming that the earlier indistinguishable barred withdrawals were loans, the taxpayer should raise the charge of inconsistency. The result at least should be the treatment of the barred withdrawals as dividends, thereby reducing the current accumulated earnings and profits account by the previous withdrawals; at best, it should be a conclusion by the court that all of the withdrawals were bona fide loans. By analogy to the case-law construction of "inconsistent position" under the mitigation provisions of the Code, the taxpayer's assertion should not come within the doctrine of quasi-estoppel. If the taxpayer has raised the question of recomputation in negotiations with the Service, it is probable that the Commissioner would be more likely to take the above posture.

Where the government leaves the status of prior withdrawals in limbo by not recognizing or raising the question, the taxpayer's course of action becomes more difficult since raising the question may trigger application of the doctrine of quasi-estoppel. Nevertheless, because the judicial approach in the area has been not to go beyond the positions of the parties—witness the net dividend area—the taxpayer should raise the issue himself in the alternative. At worst, he is merely barred from obtaining any benefit from any possible prior exhaustion of accumulated earnings and profits. Probably the only certain resolution of the problems inherent in recomputation of earnings and profits in this area lies in legislation, but until that event occurs it is to be hoped that the courts will squarely face this problem, considering all of the policies involved as well as the trend in analogous areas.

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